

INTRASTATE OFFERING EXEMPTION: RULE 147—PROGRESS OR STALEMATE?

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After publication for one year in proposed form,¹ rule 147² under the Securities Act of 1933, as amended,³ has been adopted by the Securities and Exchange Commission, effective for transactions commenced on or after March 1, 1974.⁴ The rule, which was adopted with some significant changes from that first proposed,⁵ is designed to chart for issuers of securities a course of safe passage through the "intrastate offering" exemption from the registration requirements of § 5 of the Act.⁶ The

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¹ Rule 147 was first proposed in Securities Act Release No. 5349 (Jan. 8, 1973), CCH FED. SEC. L. RPTR. ¶ 79,617 [hereinafter cited as SA Rel. 5349].

² 17 CFR § 230.147, 1 CCH FED. SEC. L. RPTR. ¶ 2253 [hereinafter cited as rule 147]. The complete text of rule 147 is set out at note 147 *infra*.

³ Securities Act of 1933, 15 U.S.C. § 77a-aa (1970) [hereinafter cited as Act].

⁴ Rule 147 was adopted in final form in Securities Act Release No. 5450 (Jan. 7, 1974), 1 CCH FED. SEC. L. RPTR. ¶ 2253 [hereinafter cited as SA Rel. 5450]. SA Rel. 5450 provides: "The Commission, acting pursuant to the Securities Act of 1933, particularly Section 3(a)(11) and 19(a) thereof, hereby adopts Rule 147 effective for issues of securities commenced on or after March 1, 1974." The purposes of rule 147 are, as stated in SA Rel. 5450, to provide "objective standards to facilitate compliance with Section 3(a)(11) of the Act" and to "provide, to the extent feasible, more certainty in determining when the exemption provided by that Section of the Act is available." These purposes are expressed in the context of the Commission's equally compelling concerns to protect investors by coordinating and integrating the Act's continuous disclosure system with its various exemptions and to assure "that the intrastate offering exemption is used only for the purpose that Congress intended, *i.e.*, local financing of companies primarily intrastate in character." SA Rel. 5450. Rule 147 is another in the Commission's "140 Series" of rules designed "to provide protection to investors and, where consistent with that objective, to add certainty, to the extent feasible, to the determination of when the registration provisions of the Act apply." The other rules in this series are rule 144 (relating to resales of "control" and "restricted" securities), Securities Act Release No. 5223 (Jan. 11, 1972), 17 C.F.R. 230.144, 1 CCH FED. SEC. L. RPTR. ¶ 2705A; rule 145 (requiring registration of securities issued in certain business combinations), Securities Act Release No. 5316 (Oct. 6, 1972), 17 CFR 230.145, 1 CCH FED. SEC. L. RPTR. ¶ 3011A; and rule 146 (providing objective guidelines for compliance with the "non-public" offering exemption under Section 4(2) of the Act), Securities Act Release No. 5487 (April 23, 1974), Reg. § 230.146, 1 CCH FED. SEC. L. RPTR. ¶ 2708.

⁵ See notes 86, 117, 122 & 123 *infra* and accompanying text.

⁶ Section 5 of the Act, 15 U.S.C. § 77e (1970), provides:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

exemption, contained in § 3(a)(11),⁷ exempts securities that are part of an issue offered and sold only to persons resident within a single state or territory by an issuer that is a resident of and doing business within that state or territory. The rule does not provide the exclusive means for compliance with § 3(a)(11),⁸ and the rule's objective standards and definitions of statutory terms are not necessarily applicable to transactions effected outside of the rule. However, due particularly to the comprehensive scope of the rule and the refinement and narrowing it represents of certain pre-rule administrative and judicial interpretations, the rule's substantive provisions undoubtedly will have a significant effect on subsequent judicial decisions involving non-rule transactions relying on § 3(a)(11).⁹

This article is devoted, first, to an examination of the current administrative and judicial interpretations of the exemption in light of the probable impact the substantive provisions of rule 147 will have on non-rule transactions, and, second, to an analysis of the specific provisions of the rule with a view to anticipating possible interpretive and operational difficulties. Such an endeavor necessitates a preliminary consideration of the basic operation of the exemption and the current status of interpretive questions not affected by the rule. The more comprehensive

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

The articulated purpose of Congress in setting this procedure was to inform investors of facts concerning securities offered for sale and to protect investors against fraud and misrepresentation. Additionally, Congress felt this system would enable "honest enterprise" to seek capital from the public and restore the public's confidence in the securities market. For a detailed analysis of the registration process, see I L. LOSS, *SECURITIES REGULATION*, 178 et. seq. (2d ed. 1961) [hereinafter cited as LOSS].

⁷ 15 U.S.C. § 77c(a)(11) (1970).

⁸ Rule 147, Preliminary Note 1.

⁹ It is unlikely that the Commission's administrative interpretations of the exemption in non-rule transactions will be substantially different from those reflected in the rule. See notes 53-60, 110 & 116 *infra* and accompanying text.

treatment of the historical development of § 3(a)(11) is reserved to the able efforts of other commentators.¹⁰

I. THE STATUTORY EXEMPTION— PRELIMINARY CONSIDERATIONS

Section 3(a)(11) of the Act provides:

Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

(11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.¹¹

As is often the case when an exemptive provision deals with several significant concepts in few words, use of the intrastate offering exemption is fraught with legal and practical pitfalls not readily apparent from the statutory context alone.¹²

A. *Nature of Exemptive Relief; Jurisdictional Means*

Fearful by some¹³ as the most misunderstood facet of the exemption is that, notwithstanding the section's apparent grant of total exemption, it provides relief only from the registration requirements of the Act and specifically not from the antifraud provisions contained in §§ 12(2) and 17.¹⁴ With this concern in mind, the Commission repeatedly has em-

¹⁰ See 1 Loss 591-605; 11 BUSINESS ORGANIZATIONS-SECURITIES REGULATION, § 3.12 (W. Sowards ed. 1973) [hereinafter cited as Sowards—SECURITIES REGULATION]; Hertz, *Federal Securities Act of 1933—The Intrastate Exemption of § 3(a)(11)—Fact or Fiction?* 34 DICTA 289 (1957); McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 W. RES. L. REV. 110 (1964); Comment, *The Intrastate Exemption: Current Law, Local Practice and the Wheat Report*, 31 OHIO ST. L.J. 521 (1970).

¹¹ 15 U.S.C. § 77c(a)(11) (1970). As a matter of presentation, the text of this article omits reference to "territory" when discussing the exemption or the rule, although where the term "state" is used, it would be appropriate to substitute the term "territory" or add it in the disjunctive. Section 2(6) of the Act, 15 U.S.C. § 77b(6) (1970) defines "Territory" to mean "Puerto Rico, the Philippine Islands, Canal Zone, the Virgin Islands, and the insular possessions of the United States."

¹² An example of such a provision is § 4(2) of the Act, 15 U.S.C. § 77d (2) (1970), which exempts from the registration requirements "transactions by an issuer not involving any public offering," which has spawned considerable litigation and administrative enforcement actions. The Commission has recently adopted rule 146, see note 4 *supra*, to clarify the section and provide objective standards for compliance.

¹³ McCauley, *supra* note 10, at 958.

¹⁴ Section 12(2), 15 U.S.C. § 77l(2) (1970) provides:

phasized the applicability of these civil liability and antifraud provisions to securities transactions otherwise exempted from the registration requirements by § 3(a)(11).¹⁵

A similar source of confusion focuses on the relationship between

Any person who—

....

(2) offers or sells a security (whether or not exempted by the provisions of section 77c [§ 3 of the Act] of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instrument of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 17, 15 U.S.C. § 77q (1970), the Act's general antifraud section, provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

Additionally, § 3(a)(11) does not exempt an issuer from the registration, reporting, proxy solicitation, and short-swing profit provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78l(a), (b) & (g); 78m; 78n; & 78p (1970). Section 24(d) of the Investment Company Act of 1940, as amended [15 U.S.C. § 80a-24(d)], provides that Section 3(a)(11) of the Securities Act of 1933 "shall not apply to any security of which a registered investment company is the issuer . . ." Accordingly, in discussing the exemption and rule 147, it is assumed that the issuer of the securities in question is not such a registered investment company or an "investment company" as defined in the 1940 Act. *See generally*, Sosin, note 10 *supra* at 126-127. Debt securities exempt under § 3(a)(11) of the Act are also exempt from all provisions of the Trust Indenture Act of 1939, as amended, 15 U.S.C. § 77ddd(a)(4)(A) (1970).

¹⁵ See Securities Act Release No. 1459 (May 29, 1937), 17 C.F.R. 231.1459, 1 CCH FED. SEC. L. RPTR. ¶ 2260 [hereinafter cited as SA Rel. 1459]; Securities Act Release No. 4434 (Dec. 6, 1961), 17 C.F.R. 231.4434, 1 CCH FED. SEC. L. RPTR. ¶ 2270 [hereinafter cited as SA Rel. 4434]; SA Rel. 5349; and SA Rel. 5450.

use of the mails or facilities of interstate commerce in connection with the offer or sale of securities, and the availability of the exemption and the applicability of the antifraud provisions. The applicability of both the registration provisions of § 5 and the antifraud provisions of §§ 12(2) and 17 is jurisdictionally limited to those transactions involving the direct or indirect use of any means or instruments of transportation or communication in interstate commerce ("facilities of interstate commerce") or use of the mails,¹⁶ collectively referred to as the "jurisdictional means." Liability under the antifraud provisions is conditioned upon use of the mails or facilities of interstate commerce in connection with a particular offer or sale of securities,¹⁷ and such liability exists notwithstanding full compliance with § 3(a)(11).¹⁸ Conversely, the intrastate offering exemption is not dependent on non-use of the mails or facilities of interstate commerce in any phase of distribution,¹⁹ although liability for any particular sale is likewise conditioned upon use of the jurisdictional means.²⁰ Accordingly, securities issued in a transaction complying with the intrastate exemption may be offered and sold without registration through use of the mails and the facilities of interstate commerce, may be advertised for sale by radio and television or newspapers or other means of communication that may also reach residents of other states (provided the offer is expressly limited to residents of the issuer's state of residence), and may be delivered after sale to resident purchasers through the mails or by facilities of interstate commerce.²¹ Delivery by such means could even be effected directly to a resident pur-

¹⁶ See notes 6 & 14 *supra*.

¹⁷ *Id.*

¹⁸ See *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152, 154 (5th Cir. 1969) where the court, after affirming the district court's holding that the § 3(a)(11) exemption was satisfied, stated:

The District Court, however, further found that the above conclusion disposed of all other issues. With this we do not agree and must therefore again remand this case to the District Court for further proceedings on all other issues raised in the pleadings, namely sections 12(2) and 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Act of 1934. Actions under these sections may be pursued even though the securities are exempt from registration requirements, and plaintiffs below were entitled to be heard on these issues.

See also *Pawgan v. Silverstein*, 265 F. Supp. 898, 900-01 (S.D.N.Y. 1967); Sowards—SECURITIES REGULATION at 3-34.

¹⁹ SA Rels. 1459 & 4434. If non-use of the mails or facilities of interstate commerce were required, there would be no need for the § 3(a)(11) exemption since the transaction would necessarily be outside the jurisdictional limits of § 5 of the Act.

²⁰ See note 6 *supra* and notes 44 & 45 *supra* and accompanying text. See also 1 LOSS 207-211.

²¹ SA Rels. 1459 & 4434. See also 1 LOSS 602; Sowards, *The Intrastate Exemption*, 2 REV. SEC. REG. 922-923 (1969).

chaser who may be temporarily out of state or to his designated non-resident agent or custodian.²²

Despite the location of the exemption in § 3 of the Act which purports to exempt the complying securities from the registration requirements forever,²³ the intrastate exemption is regarded as a transactional exemption from registration similar to the exemptions afforded under § 4 of the Act.²⁴ Accordingly, § 3(a)(11) is available only with respect to the offer and sale of securities in a transaction then meeting all requirements of the Section, and each subsequent offer or sale of those securities by jurisdictional means must either be effected pursuant to registration or under circumstances then qualifying for one of the exemptions from registration contained in §§ 3 or 4 of the Act.²⁵

B. Civil Liability

Loss of the exemption can have disastrous consequences for the issuer and others involved in selling the securities. The civil liability provisions of § 12(1) provide that "any person who offers or sells a security" in violation of the registration and prospectus requirements of § 5 is liable to the purchaser for rescission or for damages if the purchaser no longer owns the security.²⁶ Moreover, § 15 of the Act imposes on each person who controls a person liable under § 12 joint and several liability to the same extent as the controlled seller, subject to a defense of lack

²² SA Rel. 1459.

²³ See text accompanying note 11 *supra*.

²⁴ See SA Rel. 1459, 4434, 5349, & 5450. For an opposing view contained in the legislative history of the exemption, see the memorandum prepared by the sponsor of the 1934 amendment which relocated the intrastate exemption under § 3(a) from § 5(c) of the Act where it had originally appeared. That memorandum stated:

The primary purpose of the amendment is to make clear that the exemptions accorded by the present sections 4(3) and 5(c) of the act extend beyond the particular transactions therein covered, to the security itself. Considerable confusion has existed on this point, and the amendment is merely a confirmation of interpretations of the sections by the Commission.

78 CONG. REC. 8669 (1934). This historical fragment has not been specifically discussed by the Commission or in the reported cases. The amendment to § 3(a)(11) and its predecessor are summarized in note 48 *supra*.

²⁵ "Persons who acquire securities from issuers or affiliates in transactions complying with the rule would acquire unregistered securities that could only be reoffered and resold pursuant to an exemption from the registration provisions of the Act." SA Rel. 5450. See also 1 LOSS 708-710.

²⁶ 15 U.S.C. § 77l(1) (1970) provides:

Any person who (1) offers or sells a security in violation of section 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

The same rescissory and damage remedies are available under § 12(2). See note 14 *supra*.

of either knowledge of or reasonable grounds to believe in the existence of the facts on which the controlled person's liability is based.²⁷ Sellers liable under § 12(1) are a purchaser's immediate seller and that seller's selling agents (*e.g.*, the issuer and its agents in a non-underwritten offering, and the issuer and the underwriter and its agents in a "best-efforts" underwriting).²⁸ Where ownership of the securities has passed, however quickly, through additional hands in the distribution process before reaching the ultimate purchaser, each buyer in the chain may recover from, and only from, his immediate seller and its agents. For example, in a "firm-commitment"²⁹ underwriting involving one or more underwriters who purchase the securities from the issuer directly for resale to the public or in part for resale to participating dealers who in turn sell to the public, the ultimate investor could recover only from the dealer selling to him; that dealer could in turn recover only from the underwriter or underwriters; and the latter only from the issuer.³⁰

Since each purchaser of any of the securities comprising a part of an offering for which the exemption is lost is entitled to rescission or damages with respect to his transaction, whether or not that particular transaction caused the loss of the exemption,³¹ issuers and underwriters and their respective controlling persons face ultimate liability for the aggregate selling price, plus interest, of the entire offering. Participat-

²⁷ Section 15 of the Act, 15 U.S.C. § 77o (1970) provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Rule 405 under the Act, Reg. § 230.405 (1947), defines "'control' (including the terms 'controlling,' 'controlled by' and 'under common control with')" to mean "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise." See also Sommer, *Who's "In Control"?*—S.E.C., 21 BUS. LAW. 559 (1966).

²⁸ In a "best-efforts" underwriting, the underwriter commits to sell the securities on behalf of the issuer as its agent and its compensation takes the form of an agent's commission. See 1 LOSS 171-72.

²⁹ In a total "firm-commitment" underwriting, the underwriter or underwriters contract to purchase the entire issue of securities from the issuer at a fixed price and resell them to participating dealers and the public at the higher public offering price (less a concession to dealers). See 1 LOSS at 163-71.

³⁰ For a general discussion of these liabilities, see Sosin, note 10 *supra*, at 117-21; 3 LOSS 1692-98 & 1712-20 (1961); 6 LOSS 3827-31 & 3834-42 (1961).

³¹ SA Rel. 4434; 1 LOSS at 592-93.

ing dealers face similar liability to the extent of their own selling activities.³²

As can be seen, issuers and underwriters are subjected to liability not only for claims based on their own or their agents' activities causing a loss of the exemption, but, presumably, also for claims based on such activities by others, such as prohibited resales by investors or dealers having no connection with the offering. Should the issuer or the underwriter be liable in the latter situation, assuming it acted in good faith and the disqualifying element was free of any taint of conspiracy or subterfuge on its part? Professor Loss persuasively argues that the issuer, at least, should not be liable:

Unless the standard [for issuer liability] is one of due care—which includes reasonable supervision of all selling agents and may well require something more than an automatic acceptance of the buyer's [residency] representation—the exemption is virtually read out of the statute. Perhaps it should be. But that presumably is why Congress sits. Meanwhile, although it is usually impracticable to litigate with the Commission when an issuer is primarily interested in completing its financing, a seller against whom a claim is made for rescission or damages under § 12(1) would be well advised to defend if he thinks he used reasonable care.³³

Although the question of liability may depend upon a failure to conform to some standard of care, this rationale has not prevented the Commission from seeking injunctions against the issuer and others prohibiting further sales after the exemption has been lost.³⁴

³² This catastrophic liability potential has motivated many issuers and underwriters (and to a lesser degree, participating dealers) to enter into complex cross-indemnification arrangements in underwritten intrastate offerings for purposes of allocating the potential liability among them based on some semblance of causation or fault for loss of the exemption. However, a party to such indemnification agreements may not be able to recover damages under circumstances where it participated in, or perhaps, had actual knowledge of, transactions or events clearly causing a loss of the exemption. See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1287-89 (2d Cir. 1969), holding that an underwriter which had actual knowledge of an omission of material facts in an offering circular could not enforce an indemnity agreement against the issuer and its officers when an action was brought by shareholders of the corporation charging the president of the corporation and the underwriter with violations of the federal securities laws.

³³ 1 LOSS 604-05. The Commission has provided (perhaps unwittingly) some support for a standard of due care in SA rel 4434: "The mere obtaining of formal representations of residence . . . should not be relied upon *without more* as establishing the availability of the exemption. . . ." [emphasis added]. Perhaps the "more" is diligent inquiry and the reasonable supervision of selling agents suggested by Professor Loss. Rule 147, however, allows no room for a due care standard in view of the provisions of subparagraph (d) which provides that offers and sales ". . . shall be made *only* to persons resident within the state. . . ." [emphasis supplied].

³⁴ *Id.* 604. Other sanctions available to the Commission include revoking the broker-dealer registration of the principal underwriters; requiring, as part of a subsequent registration, an offer of rescission and redemption of all sales consummated as part of the non-

What of the liability of dealers effecting transactions in the securities as nonparticipants in the intrastate distribution? If the dealer represents only the buyer and the sale is executed upon an unsolicited order from his customer, that transaction by the dealer is exempt from registration under § 4(4) of the Act.³⁵ If the dealer (including an underwriter no longer acting as such) is acting as principal or solicits the buy order, the transaction is also exempt, under § 4(3), unless it takes place "prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or through an underwriter," or unless the security sold by the dealer constitutes all or any part of his unsold allotment as a dealer participating in the offering.³⁶ Accordingly, the nonparticipating dealer acting as principal or as agent in a solicited sale will be exposed to liability with respect to his transactions during the forty-day period should the intrastate exemption be lost for any reason, whether or not caused by that dealer.³⁷ This risk is aggravated by the fact that a nonparticipating

exempt offering; requiring disclosure of the issuer's contingent liability under § 12(1) in such registration and in reports filed under § 13 of the Securities Exchange Act of 1934; and recommending criminal prosecution. See 31 OHIO ST. L.J., *supra* note 10, at 532.

³⁵ 15 U.S.C. § 77d(4) (1970) provides: "The provisions of section 77e of this title shall not apply to . . . (4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." See also 1 LOSS 700-06; 4 LOSS 2666-73.

³⁶ 15 U.S.C. § 77d(3) provides:

The provisions of section 77e of this title shall not apply to—

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter.

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 77h of this title is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

³⁷ See 1 LOSS 595-97. See also SA Rel. 1459. In SA Rel. 4434 the Commission stated: "It is incumbent upon the issuer, underwriter, dealers and other persons connected with the offering to make sure that it does not become an interstate distribution through resales. It is understood to be customary for such persons to obtain assurances that purchases are not made with a view to resale to nonresidents."

dealer usually is remote from the initial offering and cannot readily ascertain whether or not the exemption is available or even know when the offering commenced (for purposes of computing the forty-day period). The caveat to the nonparticipating dealer is apparent—it should assure itself as to the date of the commencement of the offering and refrain from soliciting or effecting as principal resales even to residents for at least forty days, and, if the offering has not by then been completed, it should consider refraining further until completed lest it appear to be a participant in the distribution.

Even if the nonparticipating dealer's transactions are exempt as to it under § 4(3), that dealer's resales to nonresidents after the forty-day period of securities that are part of an offering still in progress could then destroy the exemption for the entire offering, resulting in liability for the underwriter or participating dealer selling to such nonparticipating dealer, and, quite possibly, for the issuer.³⁸

Perhaps due in part to this large liability exposure § 13 of the Act³⁹ provides a relatively short statute of limitations. Actions for recovery under § 12(1) must be brought within one year of the alleged violation, but in no event later than three years after the security was bona fide offered to the public. As a result of this overriding three-year limitation, Professor Loss has observed that "it is literally possible for the statute to expire before the purchaser acquires the security in the case of a very slow offering which may still be going on after three years!"⁴⁰

C. *Strict Construction; Commission Attitude*

Because the Act is remedial, the burden of proving the availability of an exemption rests with the person seeking to rely upon it,⁴¹ and the terms of the exemption are strictly construed against the claimant.⁴² For

³⁸ *Id.*

³⁹ 15 U.S.C. § 77m (1970) provides:

No action shall be maintained to enforce any liability created under section 77k or 77l(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 77l(1) of this title, unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 77k or 77l(1) of this title more than three years after the security was bona fide offered to the public or under section 77l(2) of this title more than three years after the sale.

⁴⁰ 3 LOSS 1743.

⁴¹ SA Rel. 4434, 5349, 5450; *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *SEC v. Culpepper*, 270 F.2d 241, 246 (2d Cir. 1959); *SEC v. McDonald Invest. Co.*, 343 F. Supp. 343, 346 (D. Minn. 1972).

⁴² SA Rel. 4434, 5349, & 5450; *SEC v. Sunbeam Gold Mining Co.*, 95 F.2d 699, 701 (9th Cir. 1938).

example, it is clear that a single sale or a single offer—whether or not accompanied by a subsequent sale and irrespective of the fact that the offering was terminated prior to any sales—to a nonresident will destroy the exemption.⁴³ If all the securities are not offered and sold in complete compliance with the exemption, the exemption is lost forever not only for the noncomplying securities but for all the securities constituting a part of that issue, including that portion offered and sold exclusively to residents and otherwise in compliance with the exemption.⁴⁴ This is true even if the noncomplying element of the offering did not involve use of the mails or facilities of interstate commerce, although only those purchasers (whether resident or nonresident) purchasing their securities through jurisdictional means would be entitled to recovery of their investment under the civil liability provisions of the Act discussed under the preceding caption.⁴⁵

Nor is there any relief for "de minimus" transgressions.⁴⁶ In one Commission proceeding where an applicant for registration as a broker-dealer under the Securities Exchange Act of 1934 had previously effected an unregistered offering of 30,000 shares of its common stock for an aggregate of \$150,000, twenty of these shares (.07%) were found to have been sold to a resident of a bordering state for \$100. The Commission concluded that this single, minimal sale to a nonresident destroyed the intrastate exemption for the entire offering and that the resulting violation of § 5 was a sufficient basis for denying the broker-dealer application.⁴⁷

The exemption for purely intrastate offerings has been a part of the Act since 1933, and has survived to date without substantive change.⁴⁸

⁴³ See *Professional Investors, Inc.*, 37 SEC 173 (1956) (denial of broker-dealer registration of Indiana broker because of sale of 20 of 30,000 shares to single Illinois resident); *Universal Serv. Corp.*, 37 SEC 559 (1957) (single sale to nonresident destroying exemption); *Ned J. Bowman*, 39 SEC 879 (1960) (mere offer to a nonresident would defeat the exemption); *Belhumeur v. Dawson*, 229 F. Supp. 78 (D. Mont. 1964) (single sale to nonresident defeats the exemption).

⁴⁴ SA Rel. 4434 provides: "If any part of the issue is offered or sold to a nonresident the exemption is unavailable not only for the securities so sold, but for all securities forming a part of the issue, including those sold to residents."

⁴⁵ See 1 Loss 593.

⁴⁶ *Associated Investors Securities, Inc.*, 41 SEC 160 (1962); *Professional Investors, Inc.*, 37 SEC 173 (1956); *Capital Funds, Inc. v. SEC*, 348 F.2d 582 (8th Cir. 1965). In *Capital Funds*, the court found that the sale of two blocks of 1,000 shares (out of a total offering of 60,000 shares) to nonresidents destroyed the exemption.

⁴⁷ *Professional Investors, Inc.*, 37 SEC 173 (1956).

⁴⁸ The exemption first briefly appeared as § 5(c) of the Act and provided: The provisions of this section relating to the use of the mails shall not apply to the sale of any security where the issue of which it is a part is sold only to persons resident within a single State or Territory, where the issuer of such securities is a person resident and doing business within, or, if a corporation, incorporated by

The Commission consistently has maintained the legislative purpose to be that of affording an exemption only to local financing by local investors for local businesses where the distribution of securities is genuinely local in character.⁴⁹ The most comprehensive judicial review of the legislative purpose of the intrastate exemption is contained in the opinion of the Sixth Circuit in *Chapman v. Dunn*.⁵⁰ The Court concluded that the broad legislative purpose of § 3(a)(11) was to exempt from registration only those issues of securities which were being effectively regulated by state authorities, and implied that the Commission's concept of genuinely local financing is wholly consistent with this interpretation of the legislative intent.⁵¹ The Commission, because of the obvious practical and political difficulties in assessing the regulatory capabilities of state securities agencies on a case-by-case basis, has not relied on the *Chapman* approach in determining the availability of the exemption, and seems content to rely on a more uniform approach of narrowly construing the terms of the exemption within the Commission's more general concept of "local financing for local businesses."⁵²

When attempting to anticipate the Commission's position with respect to the exemption's applicability to specific rule 147 and non-rule transactions, it is important to be aware that the Commission appears to have developed a visceral distrust of the exemption—beyond that which skeptics might ordinarily suspect a regulatory agency to hold for a troublesome exemption. This attitude may be spawned by a difficulty in reconciling the exemption with the overall disclosure objectives of the Act, particularly in public intrastate offerings, and is reflected by more than the Commission's history of narrow construction. It may be most recently observed in the following text from the Commission's explanatory release adopting rule 147, which appears to cast doubt on the wisdom of the exemption:

and doing business within, such State or Territory. 38 Stat. 74 (1933).

As part of a package of other amendments to the Act, original § 5(c) was repealed and re-enacted as § 3(a)(11) in Title II of the legislation better known for its passage of the Securities Exchange Act of 1934, 48 Stat. 881 (1934). Section 3(a)(11) has remained untouched since, with the one exception contained in the general amendments to the Act in 1954 which added the words "offered and" preceding the word "sold." The effect of this amendment was to preserve (not enlarge) the exemption's prohibition against interstate offers as well as interstate sales and was necessitated by that portion of the 1954 amendments establishing a separate definition of the term "offer" which had theretofore been included within the definition of "sale."

⁴⁹ SA Rel. 1459, 4434, & 5450; SEC v. McDonald Invest. Co., 343 F. Supp. 343, 346 (D. Minn. 1972).

⁵⁰ 414 F.2d 153 (6th Cir. 1969).

⁵¹ *Id.* at 156-57.

⁵² This interpretation is stressed in both SA Rel. 5349 proposing rule 147 and SA Rel. 5450 adopting the rule.

Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. *In theory*, the investors would be protected both by their proximity to the issuer and by state regulation. (emphasis supplied)⁵³

Consistent with a doubt of the appropriateness of the exemption for intrastate offerings essentially public in character, the Commission has often cautioned that such offerings may encounter considerable difficulty in meeting the conditions of the exemption. As early as 1937, for example, the Commission's General Counsel stated:

From a practical point of view, the provisions of [Section 3(a)(11)] can exempt only issues which in reality represent local financing by local industries, carried out purely through local purchasing. In distributions not of this type the requirements of section 3(a)(11) will be extremely difficult, if not impossible, to fulfill.⁵⁴

The Commission's concern and its resulting attitude are not without merit, and will most likely continue, surfacing in its future interpretation of § 3(a)(11) and rule 147. The express purposes of the Act are to provide full and fair disclosure of securities distributed in interstate commerce and to prevent fraud in connection with such distributions.⁵⁵ The registration and prospectus requirements are designed to meet these objectives, principally that of full disclosure.⁵⁶ The exemptions contained in the Act are exemptions only from the registration

⁵³ SA Rel. 5450.

⁵⁴ SA Rel. 1459. See also Report of Special Study of Securities Markets, Securities and Exchange Commission, Pt. 1, at 571-72 (1963), [hereinafter cited as the Special Study]; Gadsby, *The Securities and Exchange Commission and the Financing of Small Business*, 14 BUS. LAW. 144, 148 (1958).

⁵⁵ The preamble to the Act has always contained the following: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." 48 Stat. 74 (1933).

⁵⁶ See House Committee Report No. 85, 73d Cong., 1st Sess. p. 8 (1933) which provides: The purpose of these sections [Sections 2(1) and 10 of the Act] is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed 'registration statement' should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. But even in respect of certain types of listed issues, reputable stock exchanges have already, on their own initiative, recognized the danger of abbreviated selling literature and insisted upon supervising the selling literature distributed in connection with such issues, to make certain that such literature includes the same information concerning the issuer required in a formal circular filed with and approved by such exchanges. Any objection that the compulsory incorporation in selling literature and sales agreements of substantially all information concerning the issue will frighten the buyer with the intricacy of the transaction states one of the best arguments for the provision. The rank and file of securities buyers who have hitherto bought blindly should be made aware that securities are intricate merchandise.

requirements,⁵⁷ and for the most part are justified by balancing the protections afforded by the disclosure system against the ability to enforce registration and the need for such protections in light of the nature of the issuer, the type of security, or the nature of the probable investor.⁵⁸ Purchasers of securities constituting part of a widespread public offering within a single state normally do not, in the probable view of the Commission, have any special sources of protection that distinguish them from investors in public interstate offerings, other than, perhaps, some additional state supervision in varying amounts and quality not otherwise available or exercised in interstate offerings. Consequently, it is reasonable to expect the Commission by narrow construction and aggressive enforcement to resist use of the exemption for large intrastate public offerings, and to confine its applicability to offerings more closely akin to one "by a small businessman of a limited amount of securities to his friends, relatives, business associates, and others"⁵⁹ which the Commission probably could not now effectively regulate through registration in any event. As we shall observe, the existing judicial and administrative interpretations make, and the incorporation of these and other restrictive standards into rule 147 will make, reliance upon the exemption exceedingly dangerous in large offerings necessitating involvement of the brokerage community in the distribution process.⁶⁰

II. THE STATUTORY EXEMPTION—PRINCIPAL INTERPRETIVE PROBLEMS AND THE IMPACT OF RULE 147

The principal substantive questions that have arisen in interpreting § 3(a)(11) are: (1) what constitutes "part of an issue" that must be sold exclusively intrastate, (2) what is required for an issuer to be "doing business" within a state, (3) when is an issuer and an offeree or purchaser a "resident within" a state, and (4) when may securities constituting a part of an intrastate issue be resold to nonresidents.⁶¹ For offerings made in reliance thereon, rule 147 provides objective standards

⁵⁷ See notes 14 & 15 *supra* and the accompanying text.

⁵⁸ Certain types of securities and certain types of transactions were determined by Congress to be outside this need for disclosure or to contain sufficient protections as to limit the need for disclosure. These securities and transactions were thus specifically exempted from the registration requirements of the Act. For an early discussion of the philosophy of all of the exemptions, by the then General Counsel of the Commission and his successor, see Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89 (1937). The exempted securities are set forth in § 3 of the Act; the exempted transactions are set forth in § 4.

⁵⁹ Special Study 570.

⁶⁰ See note 54 *supra* and accompanying discussion and notes 149-151 *infra* and accompanying discussion.

⁶¹ SA Rels. 4434 & 5450.

for questions (2), (3), and (4), but for the most part leaves to current judicial and administrative interpretations the "part of an issue" determination, a concept that permeates other subparagraphs of the rule. Prior to examining the interpretation and operation of the rule itself, the current status of these principal questions will be summarized in light of the principal substantive provisions of the rule, with particular emphasis on the enduring problem of determining which securities are to be deemed part of the same issue for purposes of § 3(a)(11).

A. *Part of an Issue*

Section 3(a)(11) requires that no "part of an issue" be offered and sold to nonresidents if any security comprising a part of that issue is to qualify for the exemption; *i.e.* the entire issue must be offered and sold only to residents of the state in question.⁶² The significance of this requirement is that an issuer's offers or sales of securities to nonresidents either prior or subsequent to an intrastate offering of its securities (whether of the same or a different class) may be deemed to be part of the intrastate issue, thereby destroying the exemption since all securities comprising a part of that issue were not offered and sold exclusively to residents.⁶³ In the jargon of the trade, the offers and sales to nonresidents would be "integrated" with the intrastate offering. This is true even though the sale of the securities to nonresidents was exempt under §§ 3 or 4 or even registered under the Act—the intrastate offering exemption cannot be combined with registration or another exemption to relieve from registration that portion of the issue offered and sold out of state.⁶⁴ The problem is compounded when reliance for the interstate portion of the issue is placed on an exemption having its own integration problems.⁶⁵ For example, if an Ohio issuer needing approximately

⁶² See releases and cases cited in notes 41 & 42 *supra*.

⁶³ See *Shaw v. United States*, 131 F.2d 476 (9th Cir. 1942) (rejection of appellant's claim that each sale or exchange of original issued shares of a common character is a separate issue); *SEC v. Los Angeles Trust, Deed & Mortgage Exchange*, 186 F. Supp. 830 (S.D. Cal.), *aff'd*, 285 F.2d 162 (9th Cir. 1960) (integration of sales of identical securities by a parent and its subsidiary); *Hillsborough Investment Corp. v. SEC*, 276 F.2d 665 (1st Cir. 1960) (integration of intrastate sales under a "substitute capitalization plan" with earlier sales of substantially identical securities to nonresidents in violation of § 3(a)(11)).

⁶⁴ *Edsco Mfg. Co., Inc.*, 40 SEC 865, 869 (1961); 1 Loss 593; SA Rel. 5450.

⁶⁵ The question of integration often arises in connection with the exemptions provided in §§ 3(a)(9) and 4(2). 15 U.S.C. §§ 77c(a)(9) & d (1970).

The § 3(a)(9) exemption provides that the security must be exchanged by the issuer "with its existing security holders *exclusively*" (emphasis added). The use of the word "exclusively" has led the Commission to the conclusion that the entire "issue" of securities being exchanged must be offered to existing security holders, and any offer of that issue to non-security holders will destroy the exemption for the entire issue being exchanged. Securities Act Release No. 2029 (Aug. 8, 1939, 1 CCH FED. SEC. L. RPT. ¶ 2140).

\$1,000,000 to purchase a complex piece of manufacturing equipment financed that acquisition by selling \$500,000 worth of its common stock for investment to a single large corporate institutional investor residing in New York in reliance on the private offering exemption of § 4(2), and by concurrently selling a like amount of such stock in a public offering exclusively to residents of Ohio in reliance on § 3(a)(11), then neither exemption would be available since part of the issue was sold publicly without meeting the standards of § 4(2) and another part of the same issue was sold to a nonresident in noncompliance with § 3(a)(11).

Another likely situation bearing an integration problem may occur when a company seeks to raise capital for general corporate purposes without registration pursuant to an exempt intrastate offering. As things develop, the company is overly optimistic and soon dries up its local sources investment capital and halts the offering after it is only partially sold. Still in need of capital, the company then locates an underwriter willing to handle the balance of the issue; however, the underwriter is able to sell the issue only if it has available the broader market provided by its nonresident customers, or an interstate network of participating dealers, or both. Depending on the size of the offering, a notification is then filed with the appropriate Regional Office of the Commission under Regulation A,⁶⁶ or a registration statement is filed with the Commission's main office in Washington, D.C. In either event, the Commission could be expected to integrate the original intrastate and proposed interstate offerings and consider § 3(a)(11) unavailable to the prior offering. In

The § 4(2) exemption covers transactions "not involving any public offering" (emphasis added). The Commission has interpreted the word "offering" to require integration of offers to sell, offers for sale or sales of securities which are a part of the same "offering" if it finds that the particular facts and circumstances warrant such treatment. Securities Act Release No. 4552 (Nov. 6, 1962), 1 CCH FED. SEC. L. RPTR. ¶ 2770-2783. Rule 146, note 4 *supra*, preserves the integration problem with no guidance in addition to an endorsement of the 1962 release.

⁶⁶ 15 U.S.C. § 77c(b) (1970) authorizes the Commission to adopt rules and regulations exempting issuances of securities where the aggregate amount offered to the public does not exceed \$500,000 if it finds that registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." Pursuant to that authorization, the Commission has adopted Regulation A, 17 C.F.R. §§ 230.251-230.262, 1 CCH FED. SEC. L. RPTR. ¶ 2359-¶ 2370, exempting from registration offerings of issues up to \$500,000. The availability of this exemption depends upon compliance with the terms and conditions of Regulation A, including the filing with the appropriate regional office of the Commission of a Form 1-A notification accompanied (in the case of offerings in excess of \$50,000) by an offering circular disclosing information required by the Regulation and a specified waiting period prior to the effectiveness of the exemption. Like the § 3(a)(11) exemption, the exemption provided by Regulation A is only from the registration requirements and not the antifraud provisions of the Act. As presently administered, this "exemption" is more like a short form registration statement than an exemption from registration. For a detailed discussion of this exemption, see Weiss, *Regulation A Under the Securities Act of 1933—Highways and Byways*, 8 N.Y.L.F. 3 (1962).

these instances, it is generally the practice of the Commission to require the notification or registration statement to cover not only the unsold balance but the previously sold securities as well, and to insist that the offering circular or prospectus disclose the contingent liability under § 12(1) and contain an offer of rescission to all prior purchasers.⁶⁷ As a practical matter, the company either would have to comply with the Commission's wishes or wait out the one-year statute of limitations when the contingent liability would cease⁶⁸ and the Commission presumably would not be justified in requiring a rescission offer.

A more complex situation arises when an issuer successfully completes, at least by its definition, an interstate offering of securities (pursuant to registration or an available exemption) and then subsequently proposes an intrastate offering.⁶⁹ The question presented under § 3(a)(11) is whether or not the two seemingly independent offerings are deemed to be integrated, or more precisely, part of the same issue. The question that must be answered has been expressed as whether there exists a "relationship between separate offers and sales of securities by an issuer which is such as to constitute a single related or continuous distribution of such securities."⁷⁰ Neither the Act nor the other rules and regulations adopted thereunder offer any guidance in this respect for they contain no definition of either "issue" or "part of an issue" as used in § 3(a)(11). There are few reported court decisions dealing with the concept of integration, and, as a result, virtually all of the interpretive gloss is provided by the Commission. With a limited exception confined to rule 147 transactions, the Commission has refrained from providing objective standards for determining when issues are to be integrated, but has stated in its 1961 general explanatory release on the intrastate exemption that whether an offering "is an integrated part of an offering previously made or proposed to be made, is a question of fact and depends essentially upon whether the offerings are a related part of a plan or program."⁷¹ This release lists five factors, "any one or more of [which] may be determinative of the question:"

- (1) Are the offerings part of a single plan of financing;
- (2) Do the offerings involve issuance of the same class of security;
- (3) Are the offerings made at or about the same time;

⁶⁷ See Sosin, *supra* note 10 at 123, for a discussion of the rescission offer procedures.

⁶⁸ See notes 39 & 40 *supra* and accompanying text.

⁶⁹ The same problem would be presented if the sequence were reversed and the intrastate offering preceded the interstate offering.

⁷⁰ McCauley, *supra* note 10, at 949.

⁷¹ SA Rel. 4434.

- (4) Is the same type of consideration to be received; and
- (5) Are the offerings for the same general purpose.⁷²

No additional elaboration is offered, nor is any contained in rule 147, which fully incorporates these five factors and perpetuates the need for a case-by-case determination.

One author suggests that factors (2) through (5) are simply detailed statements of factor (1), *i.e.* whether the offerings are part of a single financing plan.⁷³ This approach deserves considerable weight in determining a particular offering's susceptibility to integration, since it is difficult to foresee an actual situation in which offerings possessing the first factor would not also include at least one of the remaining four. Likewise, if most or all of the last four factors were present, it would be difficult to disprove a single financing plan. As a practical matter, the Commission has tended to stress the last four factors, particularly time proximity and same class,⁷⁴ as evidence of a single plan of financing since these four are less subjective and are more capable of verification. For example, in one recent response to a request for a "no-action letter"⁷⁵ the

⁷² *Id.*

⁷³ Sosin, *supra* note 10, at 124.

⁷⁴ In this regard, SA Rel. 5450 provides "... the Commission, generally has deemed intra-state offerings to be 'integrated' with those registered or private offerings of the same class of securities made by the issuer at or about the same time." SA Rel 5349 proposing rule 147 had stated that the rule would do away with the case-by-case determination previously required and would automatically integrate all securities sold by the issuer, its predecessor and affiliates within any consecutive six month period. Possibly because of the adverse reaction to this "automatic integration" provision by members of the bar, the Commission reversed its position and returned to the case-by-case approach. See Letter from certain members of the Securities Law Committee of the Chicago Bar Association to Mr. Richard H. Rowe, Associate Director, Division of Corporation Finance, March 12, 1973.

⁷⁵ A "no-action letter" is an informal written position of the staff of the Commission as to a specific interpretive question (often the applicability of the registration requirements of the Act) rendered in response to a particular factual situation detailed in the requesting letter. The response gets its name from the concluding paragraph of a letter favorable to the proponent in which it is often stated that "on the basis of the facts presented the staff will not recommend that the Commission take any action if the securities are sold without registration under the Act," or words to that effect. The "no-action" process has been described as "an outstanding example of administrative accessibility and pragmatism, enabling stockholders readily to determine whether a contemplated sales transaction may be consummated without registration." See Recommendation No. 19, Admin. Conf. of U.S., 1970-71 Report, '70-'71 CCH DEC. ¶ 78,187 (1971). While the interpretive responses and "no-action" letters of the Commission's staff are not law in the sense that they have been adopted through proper administrative rule-making procedures, their practical effect in a particular transaction is substantial. The published responses of the staff generally indicate the Commission's current thinking with respect to the interpretative question posed but generally include little analysis of the factors leading to the conclusion reached. The Commission's view of the status of these responses is indicated in Securities Act Rel. No. 5098 (Oct. 29, 1970), which adopted § 200.81 (17 C.F.R. § 200.81) and § 200.90 (17 C.F.R. § 200.80) providing for the public availability of requests for and responses to "no action" and interpretative letters, where it stated: "It should be recognized that no action

Commission's staff found three of the last four factors to exist and concluded the exemption to be unavailable in these words:

The proximity in time of the two proposed offerings, the similar consideration to be received, and the similar use of proceeds cause the two proposed offerings to be [in] substance one integrated scheme of financing so that the Section 3(a)(11) exemption of the 1933 Act would not apply to the notes since the common stock part of the offering would be offered out of state.⁷⁶

In response to another no-action inquiry,⁷⁷ the staff concluded that under the integration concept "a serious question as to the availability of the Section 3(a)(11) exemption" would exist in the following factual setting. A Connecticut real estate development company sold a ten-acre garden apartment project located in Connecticut to a captive Connecticut cooperative housing corporation (Co-op I), which in turn sold its shares to in-state buyers who each also acquired leasehold rights to a specific apartment unit. During the intrastate marketing of the shares of Co-op I the developer proposed to sell a separately mortgaged, adjacent garden apartment project to a new captive Connecticut cooperative housing corporation (Co-op II), which would sell its shares and leasehold rights in a registered *interstate* offering. The offerings of Co-op I and Co-op II were considered subject to integration, presumably because of their proximity in time and their common purpose in channeling to the de-

and interpretative responses by the staff are subject to reconsideration and should not be regarded as precedents binding on the Commission."

⁷⁶ Property Investments, Inc., '72-'73 CCH DEC. § 79,123 (1972). The subject issuer was a Texas corporation engaged in developing and marketing real estate in Texas. It had proposed to offer \$25,000,000 of non-convertible promissory notes exclusively to Texas residents and, shortly after the termination of this offering, to register an interstate common stock offering with the Commission. The actual time between the two offerings was not specified in either the requesting or responding letter, but the Commission nonetheless determined that the common stock and note offerings would be integrated. But see Stratford Employees' Cattle Program, Ltd. no-action letter, CCH § 79,761 (1974), where the proposed intrastate sale (non-rule 147) of interests in a Texas limited partnership cattle feeding program solely to employees of the corporate general partner and its affiliates was not integrated with the concurrent registered interstate sale of interests in other limited partnerships conducting larger but similar cattle feeding programs and having as their sole general partner the parent of the general partner in the employees' partnership. Although the intrastate and interstate offerings would take place at the same time and would be sold for cash, the Commission concluded that controlling substantial differences existed, including the price per unit (\$100 vs. \$5,000 for the interstate offerings), different general partners, different accounting methods (accrual vs. cash method for the interstate partnerships), dissimilar plans of distribution, and the different purpose of the intrastate offering (the intrastate offering to employees was designed to provide them with a convenient vehicle for investing in their own cattle feeding operation and consequently bolster their morale and performance of their employment duties to the cattle programs operated by the publicly-held limited partnerships).

⁷⁷ Presidential Realty Corp., Sylvan I Corp. and Sylvan II Corp., '70-'71 CCH DEC. § 78,066 (1971).

veloper a portion of the offering proceeds in payment of the purchase prices of the apartment projects.⁷⁸

The only reported court decision dealing specifically with the definition of "issue" for § 3(a)(11) purposes is *Shaw v. United States*,⁷⁹ a 1942 decision of the Ninth Circuit affirming a conviction for violation of the registration provisions of the Act. The court first concluded that the meaning of the term "issue" was not a question of state law and then stated that "issue" under § 3(a)(11) "includes all the shares of a common character originally though successively issued by the corporation."⁸⁰ This seemingly equates "issue" of securities with "class" of securities, and could, if carried to its logical conclusion, forever bar use of the intrastate exemption for an entire class of an issuer's securities once any unit thereof was sold to a nonresident, no matter how remote the sales in time or purpose.⁸¹ Fortunately, this needlessly broad concept has neither been advanced by the Commission nor indorsed in subsequent court decisions. Moreover, the courts have been willing to examine offerings by the same issuer within a close time proximity in light of all the surrounding facts, and to refrain from integrating the offerings when justified.⁸² On the other hand, the courts and the Commission have been quick to integrate offerings structured in form to fit within the technical requirements of § 3(a)(11), but which amounted to indirect interstate offerings of a single enterprise or transparent devices to avoid the intent and purpose of exemption.⁸³

⁷⁸ This letter illustrates the Commission's willingness to integrate issuers as well as issues when the factual pattern so requires. Another no-action letter which followed this analysis is Commercial Credit Co., '71-'72 CCH DEC. ¶ 78,544 (1971) (integration of offerings by several subsidiaries). See also Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 794-95 (1971).

⁷⁹ 131 F.2d 476 (9th Cir. 1942).

⁸⁰ 131 F.2d at 480.

⁸¹ See McCauley, *supra* note 10, at 943.

⁸² In *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152 (5th Cir. 1969), the court refused to integrate the issuance of 1,500 shares of stock to the nonresident father of the president of an issuer with a subsequent intrastate public offering of 20,000 shares of its stock. The stock issued to the nonresident was in exchange for the cancellation of a prior indebtedness and was issued prior to the registration with state authorities of the public offering. The court concluded that because the nonresident did not pay a broker's fee as purchasers in the intrastate offering did, did not enter into a stock subscription agreement with the issuer and the transaction was not on the agenda at a shareholders' meeting, this transaction should not be integrated with the intrastate offering. *Id.* at 153. A similar result was reached in *SEC v. Dunfee*, '66-'67 CCH DEC. ¶ 91,970 (W.D. Mo. 1966), where the court refused to integrate an issuer's intrastate offer and sale of six percent promissory notes payable in twenty months with an intrastate offering commenced nine months later of his seven percent promissory notes payable in thirty-six months. See note 167 *infra*.

⁸³ In *SEC v. Los Angeles Trust, Deed & Mortgage Exchange*, 186 F. Supp. 830 (S.D. Cal.), *aff'd*, 285 F.2d 162 (9th Cir. 1960), the court looked through the issuer's attempt to separate identical investment contracts being issued by it and a formerly dormant subsidi-

The author understands that for no-action letter purposes, the Commission generally does not integrate a start-up company's initial *interstate* private offering to promoters active in its inception and organization with a subsequent *intrastate* offering to others to provide substantial funds for the continued operation and growth of the enterprise,⁸⁴ although the Commission would view skeptically any attempt at artificial classification of a nonresident investor as a true "promoter." It is also doubtful that integration would occur in the common situation where construction or acquisition of a real estate project is financed in part by a first mortgage loan (evidenced by a promissory note) obtained in a private transaction from an out-of-state institution, and in part by the sale of equity securities (*e.g.*, common stock or partnership interests) to in-state residents, provided there was compliance with all other conditions of the exemption.⁸⁵ There are also strong indications that the Commission will not integrate offerings by separate and economically distinct partnerships solely because of the existence of a common general partner.⁸⁶

ary. The court concluded that since the contracts were identical and the claimed subsidiary was, in effect, a mere division of the issuer, the issuer's claim that the contracts issued by one entity were all issued to residents of California was "a mere subterfuge intended to defeat and evade the registration requirements of the Securities Act, and to create an artificial basis for the assertions of the defendant that the 'intrastate exemption' is applicable." 186 F. Supp. at 871. Similarly, in *Hillsborough Investment Corp. v. SEC*, 276 F.2d 665 (1st Cir. 1960), the court integrated a prior issuance of securities in violation of § 3(a)(11) with a claimed "recapitalization" wherein the issuer had authorized the issuance of allegedly new securities to be exchanged for those securities of the prior issue which had been sold to intrastate purchasers. The court found that this was an attempt by the corporation to regain the intrastate exemption after it was once lost and that such a result could not be permitted under the Act.

⁸⁴ See Hertz, *supra* note 10, at 294.

⁸⁵ But see Emens & Thomas, *supra* note 78, at 792, where the authors refer to a no-action letter in which the Commission's staff requested additional facts with regard to certain debt-financing arrangements, the proceeds of which were to be used along with the intrastate offering proceeds. The use made by the staff of this information and its ultimate conclusion are not revealed.

⁸⁶ Proposed rule 147 contained a limitation to its general integration requirements (*see* note 70 *supra*), to the effect that offerings of securities by separate and distinct business enterprises for separate and distinct purposes would not be deemed part of an issue solely because both issues had the same general partner. See SA Rel. 5349. Since rule 147 as finally adopted eliminated any automatic integration of offerings by affiliates (*see* rule 147(b)) the Commission deemed the limiting proviso of the proposed rule as no longer necessary. See SA Rel. 5450. Regulation A contains provisions similar to the proposed rule 147 proviso in its own "integration" section by providing:

The following securities need not be included in computing the amount of securities which may be offered under this regulation:

....

(4) In the case of an offering of interests in an unincorporated theatrical production, interests in any affiliated unincorporated theatrical production; or

(5) In the case of an offering of interests in an unincorporated issuer organized to hold title to, lease, operate or improve specific real property, interests in

Avoiding loss of the exemption as a result of prior or future interstate offers or sales of securities can be a particularly troublesome and complex matter. Careful investigation is essential to uncover any possible "integratable" offerings, and such possibilities can surface in unexpected ways, such as a result of acquisitions of businesses for securities, the offer or sale of securities pursuant to employee stock options and other incentive plans, the exercise of outstanding warrants, out-of-court settlements for securities with trade creditors, and, perhaps, concurrent debt financing arrangements.

Rule 147 does not eliminate or clarify the integration question, except for a partial elimination under limited circumstances, and it will continue to plague all offerings made in reliance upon § 3(a)(11), whether or not made under the rule.

B. *Doing Business*

Section 3(a)(11) requires that the issuer of the securities be "doing business" within its state of residency. The principal questions left unanswered by the statute are what types of activities constitute doing business, how much of such business activities must the issuer be doing within the state, and whether and to what extent can the proceeds of an intrastate offering be used to finance an issuer's out-of-state business operations. These questions are answered with great specificity and objective criteria by rule 147 for offerings made under the rule.

Case law under the Act has established that the business required to be done in the state must be "something substantially more than has been held sufficient to subject one to service of process in civil suits."⁸⁷ In addition to such "presence" in, or sufficient "minimum contacts" with, a state required for jurisdictional purposes,⁸⁸ doing business for purposes of § 3(a)(11) also means something more than the conduct of accounting and recordkeeping functions in, or the offer and sale of its securities from, that state, even if such administrative office was the principal or only such office of the issuer.⁸⁹ The critical judicial test has been whether *income-producing* operations of the business in which the issuer is selling the securities are conducted in the state.⁹⁰ In *Chapman*

any affiliated issuer organized to hold title to, lease, operate or improve other specific real property.

Rule 254(d) under the Act; 17 C.F.R. § 230.254; 1 CCH FED. SEC. L. RPTR. ¶ 2362.

⁸⁷ *Chapman v. Dunn*, 414 F.2d 153, 157 (6th Cir. 1969).

⁸⁸ See, e.g., *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957).

⁸⁹ 414 F.2d at 157-59; SA Rel. 4434.

⁹⁰ 414 F.2d at 158. See also *SEC v. McDonald Invest. Co.*, 343 F. Supp. 343, 345 (D. Minn. 1972).

v. Dunn,⁹¹ where a Michigan resident sold to local residents fractional interests in oil and gas wells located in Ohio, and the only other business activities conducted in Michigan were the recordkeeping for and management of the out-of-state oil and gas interests, the court, over a strong dissent,⁹² denied the exemption since virtually no income-producing operations were conducted in Michigan. The *Chapman* majority further held that the "issuer must conduct a *predominant amount*"⁹³ of its income-producing business in the state. Although it has been suggested that this terminology of "predominant" may be labeled as dictum under the facts since all or virtually all income-producing operations were located out-of-state,⁹⁴ it nevertheless has caused justifiable concern among members of the securities bar, particularly those representing issuers conducting intrastate offerings in states within the Sixth Circuit, and has no doubt resulted in the abandonment or restructuring of many financings.

In the recent case of *SEC v. McDonald Investment Co.*,⁹⁵ the district court, after declaring the question to be a close one, held that the doing business test was not met when a Minnesota issuer's sole business operation was to be the making of secured loans to out-of-state land developers. The court found that the issuer's income-producing operations would "consist entirely of earning interest on its loans and receivables invested outside the State of Minnesota."⁹⁶ Although the issuer would not participate in any of the land developers' operations or have any ownership interest therein, the court further concluded that the strength of the securities (unsecured general debt obligations of the issuer) sold to the in-state investors depended as a practical matter, if not legally, "to a

⁹¹ 414 F.2d 153 (6th Cir. 1969).

⁹² Dissenting Judge McAllister pointed out that "no language in the Act, itself, purports to provide that performance of substantial operational activities is an essential to a corporation's 'doing business' in the state of its incorporation." *Id.* at 161. He went on to argue that the state securities commission was well-equipped to regulate offerings of the type involved in this case and concluded that "the Michigan Corporation and Securities Commission, dealing with a Michigan corporation, could better investigate, inspect, regulate, and supervise the security transactions relating to oil wells in Ohio than the Federal Securities and Exchange Commission." *Id.* at 163.

⁹³ *Id.* at 159 (emphasis added).

⁹⁴ See 31 OHIO ST. L.J., *supra* note 10, at 530. A further precedential limitation to the *Chapman* holding was the district court's finding that two of the investors were non-residents of Michigan. Thus, even if the court had concluded the issuer was "doing business" in Michigan, the exemption would have been lost by its failure to limit offers and sales to Michigan residents. On this question, the appellate court stated: "For the purposes of this opinion we pretermitted decision of the question of whether all the sales were made to persons resident within a single state and proceed to determine whether the issuer was 'doing business' in Michigan within the meaning of the above-quoted exemption." 414 F.2d at 155.

⁹⁵ 343 F. Supp. 343 (D. Minn. 1972).

⁹⁶ *Id.* at 345.

large degree on the success or failure of land developments located outside Minnesota, such land not being subject to the jurisdiction of the Minnesota court."⁹⁷ The court cited with approval the *Chapman* "predominant amount" standard,⁹⁸ but it did not attempt to quantify "predominant" since it found, as did the *Chapman* court, that all or virtually all of the issuer's income-producing operations would be located out-of-state. The *McDonald* case, then, is more important for the holding that the lending of funds to out-of-state businesses did not constitute a type of activity that will meet the "doing business" test under § 3(a)(11).⁹⁹

Prior to *Chapman*, the Commission took the position that the doing business requirement "can only be satisfied by the performance of *substantial* operational activities in the state"¹⁰⁰ Drawing support from *Chapman*, the Commission has adopted and quantified the "predominant" test in rule 147, which generally requires that eighty percent of the issuer's consolidated gross revenues must be derived from in-state operations.¹⁰¹ In view of the rule's provisions and the Commission's statement in the accompanying release that the issuer's "principal or predominant business must be carried on"¹⁰² in its state of residency, the chances are remote that the Commission would dip appreciably if at all below the eighty-percent standard in non-rule transactions.

The Commission has introduced in rule 147 an additional, virtually unprecedented, doing-business standard by requiring that eighty percent of the issuer's consolidated assets be located in the state of its residency.¹⁰³ While this test may operate to foreclose use of the rule to some truly local businesses,¹⁰⁴ the Commission certainly now will apply some asset test to non-rule transactions, and there is no reason to believe it will be depart from the test contained in the rule.

Although rule 147 imposes very high doing-business criteria, the illustrative examples contained in the release accompanying the rule indicate the Commission will not be unduly restrictive in its interpretation of the nature of the activities that qualify as business done in-state.¹⁰⁵ In

⁹⁷ 343 F. Supp. at 345.

⁹⁸ *Id.*

⁹⁹ See note 111 *infra* and accompanying text, regarding the nature of in-state business qualifying under rule 147.

¹⁰⁰ SA Rel. 4434 (emphasis added).

¹⁰¹ Rule 147(c)(2)(i). See notes 169-170 *infra* and accompanying text.

¹⁰² SA Rel. 5450.

¹⁰³ Rule 147(c)(2)(ii). See note 173 *infra* and accompanying text.

¹⁰⁴ See note 174 *infra* and accompanying text.

¹⁰⁵ SA Rel. 5450. See notes 171-172 *infra* and accompanying text.

light of this anticipated construction by the Commission and the endorsement of the "predominant" standard by the Commission and the *Chapman* and *McDonald* courts, it is also reasonable to assume that the courts will adopt substantially the rule's eighty-percent test for purposes of defining the amount of revenues that must be produced from in-state operations in non-rule transactions. Adoption by the courts of the rule's asset test, however, is less predictable. While it is probable that some asset standard may be adopted, at least in marginal cases, the lack of judicial precedent and the possibly prohibitive character of the eighty-percent standard may offer the courts greater leeway in quantifying the asset standard, particularly where the issuer was well within the gross revenues tests and in all other respects constituted a local enterprise.

Another troublesome question, now answered for transactions relying on rule 147, is whether and to what extent the proceeds from an intrastate sale of securities can be utilized by the issuer for its out-of-state business activities. In what has become a leading case, the district court in *SEC v. Truckee Showboat, Inc.*¹⁰⁸ held the exemption unavailable to a \$4,080,000 common stock offering by a California issuer that kept its books and records in California and owned and operated a small (total assets \$12,630) wholesale pharmaceutical business in San Francisco. The proceeds of the offering, however, were to be used for the unrelated purpose of acquiring, refurbishing, and operating a hotel in Las Vegas, Nevada. Although the court in its brief opinion gave no reasons for holding the exemption unavailable, the result is clearly correct on the facts since after the offering the issuer would be conducting only a nominal amount of its income-producing activities in California. However, the case has been relied upon by the Commission as the sole basis for its sweeping statement in the release adopting rule 147 that "... substantially all of the proceeds of the offering must be put to use within the local area."¹⁰⁷ This standard is incorporated in rule 147 where "substantially" also is quantified as eighty percent.¹⁰⁸ This represents an extension of the Commission's earlier position as contained in its 1961 release where it viewed *Truckee* as requiring only that the proceeds of the offering could not be used "primarily for the purpose of a new business conducted outside the state of incorporation and unrelated to some incidental business locally conducted."¹⁰⁹ Although neither construction is supported by the court's opinion and both go well beyond that required

¹⁰⁸ 157 F. Supp. 824 (S.D. Cal. 1957).

¹⁰⁷ SA Rel. 5450.

¹⁰⁸ Rule 147(c)(2)(iii). See note 177 *infra* and accompanying text.

¹⁰⁹ SA Rel. 4434.

on the facts of the case, there is little reason to believe that the Commission will vary from the rule's use-of-proceeds test in non-rule transactions.¹¹⁰

Under the Commission's interpretation, inconsistent and unwarranted results may occur. For example, a hypothetical issuer having \$900,000 in both assets and revenues, \$100,000 of which are located or produced from operations outside the state of incorporation, would be permitted to sell common stock in an intrastate offering to raise \$100,000 for local purposes. On the other hand, the Commission's position would preclude a \$100,000 intrastate common stock offering for purposes of funding a similar, but out-of-state, operation by an identical hypothetical issuer in that state having the same \$900,000 in assets and revenues, except that they *all* are located or produced from operations in the state of incorporation.¹¹¹ In each case the investor would own an undivided interest in identical corporations having ninety percent of their assets located in-state and ninety percent of their gross revenues produced by local operations, yet, in the Commission's view, the first corporation would satisfy the statute's doing-business standard and the second would not.

A suggested approach to the use-of-proceeds question for non-rule transactions that is both compatible with the language of the statute and consistent with the concept of local financing for local businesses, is to test the issuer under the applicable standard for the amount of its in-state business both as constituted *before* and as it will be *after* the successful completion of the offering, provided the security received by the investor entitles him to an undivided interest in or a general claim against the issuer, and does not limit the interest or the claim in whole or in part

¹¹⁰ There is some supporting dicta in *SEC v. McDonald Invest. Co.* where the court stated, almost as an afterthought: "...yet to relieve [the issuer] of the federal registration requirements where none or very little of the money realized is to be invested in Minnesota, would seem to violate the spirit if not the letter of the Act." 343 F.2d 343, 346. This conclusion was not necessary to support its ultimate holding since the court had already found that the issuer's income-producing activities, after completion of the offering, would consist entirely of out-of-state activities.

¹¹¹ In SA Rel. 4434 the Commission stated: "If the proceeds of the offering are to be used primarily for the purpose of a new business conducted outside of the state of incorporation and unrelated to some incidental business locally conducted, the exemption should not be relied upon."

In *Tait v. North Am. Equit. Life Assur. Co.*, 92 Ohio L. Abs. 551, 25 Ohio Op. 2d 451, 194 N.E.2d 456 (c.p.), *aff'd per curiam*, 195 N.E.2d 128 (Ct. App. 1963), *appeal dismissed*, 176 Ohio St. 240, 199 N.E.2d 3 (1964), an underwriter failed in a breach of contract action against an issuer which terminated prior to completion a stock offering claimed to be exempt under § 3(a)(11). The issuer was newly-formed and the purpose of the offering was to raise the capital necessary to expand its fledgling life insurance business under Ohio law. During the course of the offering the issuer acquired by merger a Maryland insurance company doing the bulk of its business in that state. The offering was terminated when the staff of the Commission took the position that the intrastate exemption was no longer available since the issuer was not "doing a substantial insurance business in Ohio."

to the issuer's out-of-state operations.¹¹² The analysis would be the same whether the out-of-state business was related or unrelated to the in-state business, and the ultimate use of the proceeds would be irrelevant,¹¹³ provided the issuer was essentially a local business both before the offering and after giving effect to the application of the proceeds. Such a standard is all that is required by § 3(a)(11), which makes no reference to use of proceeds, and its application would have produced the same denial of the exemption found by the courts in the *Truckee*, *Chapman*, and *McDonald* cases. However, since the Commission has codified its use-of-proceeds interpretations in rule 147, issuers will be well-advised to conform as nearly as possible to the rule's eighty-percent test unless they are prepared to champion this suggested more appropriate, but yet unproven, standard in the courts.

C. Residency

(1) Of the Issuer

Section 3(a)(11) requires that the issuer must be resident within the state in question. Although the statute does not define residence generally, for either the issuer or the offerees and purchasers, it is specific in one respect, providing that the residency of a corporate issuer is the state where it is incorporated.¹¹⁴ No guidance for other business forms is found in Commission releases prior to the advent of rule 147,¹¹⁵ nor has

¹¹² It is essential that the investor's interest not be limited to out-of-state enterprises of the issuer, even if that issuer would, viewed as a whole, qualify as "doing business" in-state. In *Chapman v. Dunn*, the court stated: "This business which the issuer must conduct within the same State refers to the income producing operations of the business in which the issuer is selling the securities, which in this case was the oil and gas development operations located solely in Ohio. . . ." 414 F.2d 153, 159 (6th Cir. 1969) (emphasis added). The Commission also stressed this factor prior to *Chapman* in SA Rel. 4434:

Thus, the exemptions would be unavailable to an offering by a company made in the state of its incorporation of undivided fractional oil and gas interests located in other states even though the company conducted other business in the state of its incorporation. While the person creating the fractional interests is technically the 'issuer' as defined in section 2(4) of the Act, the purchaser of such security obtains no interest in the issuer's separate business within the state.

¹¹³ In *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824, 825 (S.D. Cal. 1957), the court emphasized that the out-of-state use of the proceeds was for business "unrelated" to the local business—the implication being that the holding might have differed if the out-of-state business were the same or related to the in-state business. Similarly, in SA Rel. 4434 the Commission stated that if the proceeds of an offering are to be used for a new business "unrelated to some incidental business locally conducted," the exemption should be denied.

¹¹⁴ 15 U.S.C. § 77c(a)(11) (1970) provides that the residency of a corporate issuer is the state or territory by which it was incorporated and within which it is doing business.

¹¹⁵ Prior to rule 147, the Commission staff struggled with the question of the state of residency of partnerships in at least two no-action letter responses, and arrived at inconsistent conclusions. In *American Plan Invest. Corp.*, '70-71 CCH DEC. § 78,044 (1971),

the question of what constitutes residency of either issuers or offerees and purchasers been litigated in any reported case. For purposes of offerings under rule 147, the rule provides specific guidance as to the residency of issuers in noncorporate form, including natural persons, limited partnerships, trusts, general partnerships, and other forms of business organizations.¹¹⁶ In the absence of prior court decisions and since the Commission is highly unlikely to adopt an interpretation inconsistent with rule 147, the rule's practical and workable definitions of issuer residency should prevail in non-rule transactions. The rule clears up one previously encountered element of confusion concerning unincorporated issuers, particularly partnerships and trusts, where the question had been whether the residency of the individual partners or trustees controlled, or whether the state of organization or principal place of business controlled. Under the rule, the latter considerations govern.¹¹⁷

The question of issuer residency can be a special problem in the offer and sale of subdivided interests in production leases for oil and gas properties. The Commission published the following warning in 1934, and has yet to change it:

It must be remembered . . . that there may be more than one issuer for the same royalty interest where there have been successive subdivisions. To secure this exemption, all of the issuers must be residents of the State or Territory where the offering is made.¹¹⁸

With respect to the use of the exemption by a controlling person of the issuer, the Commission stated in the 1961 release:

A secondary offering by a controlling person in the issuer's state of incorporation may be made in reliance on a section 3(a)(11) exemption provided the exemption would be available to the issuer for a primary offering in that state. It is not essential that the controlling person be a resident of the issuer's state of incorporation.¹¹⁹

the staff concluded that the issuance of securities by an Illinois limited partnership with a California corporation as general partner would actually be an issuance of securities of the corporation and the § 3(a)(11) exemption would be "clearly unavailable." In *Louisiana Motor Inns*, '72-'73 CCH DEC. ¶ 78,902 (1972), the staff concluded to recommend no action if a Louisiana limited partnership with three individual residents of Louisiana and an Alabama corporation as general partners offered limited partnership interests exclusively to Louisiana residents in reliance upon the § 3(a)(11) exemption.

¹¹⁶ Rule 147(c)(1)(i)-(iii). See notes 178-180 *infra* and accompanying text.

¹¹⁷ Rule 147(c)(1)(i)-(ii). See note 115 *supra* for the Commission staff's position prior to the adoption of the rule. The proposed rule had required that all general partners in a limited partnership be residents of the state in which the partnership was organized to qualify for the exemption. See also 1 LOSS at 598-600 for a further discussion of issuer residency questions.

¹¹⁸ Securities Act Release No. 33-185, 17 C.F.R. § 231.185 (June 20, 1934). See also SA Rel. 4434 and the text thereof, *supra* note 112.

¹¹⁹ SA Rel. 4434.

The Commission reaffirmed this position in the release adopting rule 147, after making it clear that the rule itself is available only to the issuer and not to the controlling persons.

(2) Of Offerees and Purchasers

Rule 147 also provides specific answers to the determination of the residency of offerees and purchasers, including natural persons, corporations, trusts, partnerships, and other business organizations.¹²⁰ Again, it is reasonable to expect the Commission and the courts to adopt these practical and workable definitions in non-rule transactions.

The rule's definition of the residency of an individual as the state or territory where he has his principal residence represents a significant change from the Commission's prior concept of residency. Until the adoption of the rule, the Commission had consistently equated a person's "residence" with his "domicile," complete with the latter concept's esoteric requirement of an intent to maintain an abode in a certain state for an indefinite period of time.¹²¹ As first proposed in January 1973, rule 147 codified the Commission's historical position by providing that an individual, in order to be deemed a resident, must have his principal residence in the state and must not have any present intention of moving his principal residence to another state.¹²² The Commission stated in the release accompanying the final rule that it deleted the intent requirement because of the difficulty in determining a person's intentions.¹²³ However, the Commission cautioned that "[t]emporary residence, such as that of many persons in the military service, would not satisfy" the test of principal residence.¹²⁴ Presumably, this caveat should not be construed as a subtle reintroduction of the element of intent, although the opportunity to do so is present since the concept of temporary residence could presuppose a short departure from another, more permanent, residence to which the individual intends to return. Assuming the Com-

¹²⁰ Rule 147(d)(1)-(3). See notes 181-185 *infra* and accompanying text.

¹²¹ See McCauley, Hertz, and 31 OHIO ST. L.J., *supra* note 10, at 945-948, 295-303 and 527-529, respectively, for a comprehensive discussion of the "residence vs. domicile" problem.

¹²² Proposed rule 147(d)(2) provided: "An individual shall be deemed to be a resident of a state . . . if such individual has . . . his principal residence in the state . . . and has no present intention of moving his principal residence to a different state. . . ." Although SA Rel. 5349 stated that the proposed rule "does abandon the domicile test and attempts to provide more objective standards for determining when a person is considered a resident," the actual wording of the proposed rule would have required, as a practical matter, an analysis very similar to that involved in determining a person's domicile under the prior administrative test.

¹²³ SA Rel. 5450.

¹²⁴ *Id.*

mission meant the full import of its words regarding the deletion of the intent requirement, the reference to temporary residence is best interpreted to depict a situation, such as the relocation of military persons from camp to camp for short periods of time, where it is known that the residency in that state will revert or change to another within a relatively short period of time as a result of known facts or external forces, whether or not the individual intends or desires, or has any practical control over, a move to another state. The reference to temporary residence in the military context is also consistent with, and probably motivated by, the Commission's belief that military posts have been prime targets for purveyors of unregistered securities,¹²⁵ who have oftentimes employed fraudulent practices.

The use of any subterfuge that would circumvent the residency test will, of course, be disallowed. For example, the use of a nominee resident agent to buy securities on behalf of nonresidents was first squelched by the Commission in 1934,¹²⁶ and the resident agent utilizing such a device could well find himself an unwitting statutory underwriter with the incumbent liabilities associated with participation in an unlawful distribution of unregistered securities.¹²⁷ Similarly, careful counsel have advised against the formation of a new or resurrection of a dormant resident corporation solely for the purpose of affording the nonresident shareholders thereof a vehicle for purchasing securities in an intrastate offering, particularly if the corporation has no substantial economic purpose other than ownership of those securities.¹²⁸

In its 1961 release, the Commission noted that in connection with underwritten intrastate offerings "the nonresidence of the underwriter or dealer is not pertinent so long as the ultimate distribution is solely to residents of the state."¹²⁹ This statement by the Commission should not

¹²⁵ McCauley, *supra* note 10, at 946 n.38.

¹²⁶ Securities Act Release No. 33-97, 17 C.F.R. § 231.97 (Dec. 28, 1933). See also SA Rels. 201, 4434, & 5450. In *Capital Funds, Inc. v. SEC*, 348 F.2d 582 (8th Cir. 1965), the court agreed with the Commission that a subscription of stock in the name of a Florida resident with the intent to transfer the stock to an out-of-state purchaser, followed by the transfer to that purchaser, caused a loss of the § 3(a)(11) exemption.

¹²⁷ 15 U.S.C. § 77b(11) defines "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. . . ." For examples of the broad scope of this definition and the type of activities constituting one an underwriter, see *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966); *SEC v. Mono-Kearsarge Consol. Min. Co.*, 167 F. Supp. 248 (D. Utah 1958); and *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex.) *aff'd*, 448 F.2d 652 (5th Cir. 1971).

¹²⁸ See note 182 *infra* and accompanying text.

¹²⁹ SA Rel. 4434.

afford complete comfort to the nonresident underwriter or dealer in an underwriting where it acquires ownership of the securities, however temporarily, prior to resale. The problem is compounded considerably if the underwriter or dealer, as a result of a slow-selling offering, retains ownership of the securities for a period of time approaching that of constituting the underwriter or dealer an investor, rather than a distributor, of the securities. A violation would surely occur if the offering were terminated while the nonresident underwriter or dealer retained ownership.¹³⁰

Outstanding options and warrants can be particularly troublesome when originally sold in reliance on the intrastate offering exemption. Since they constitute continuing offers of the underlying securities to the holders thereof,¹³¹ a holder who moves to another state automatically places the issuer in violation of the statute if the option or warrant remains exercisable. Moreover, if the nonresident holder then exercises the option or warrant, the issuer finds itself on the horns of the proverbial dilemma since it is contractually obligated to deliver the security upon tender of payment,¹³² but will violate § 5 of the Act if it does. Consequently, careful issuers include in the options and warrants sold on an intrastate basis provisions making them nontransferable to nonresidents and exercisable only by residents.¹³³ The same problems regarding options and warrants will continue in rule and non-rule transactions.¹³⁴

Although the conversion of a convertible security constitutes a "sale" of the underlying security under the definition contained in § 2(3) of the Act,¹³⁵ the Commission administratively has determined that the stat-

¹³⁰ In response to a no-action letter request, Subaru of America, Inc., '72-'73 CCH DEC. ¶ 79,233 (1973), the staff concluded that 15,000 shares of stock received by an underwriter as compensation in a 1968 intrastate offering and an additional 5,000 shares received by the president of the underwriter as a "gift" from the issuer's president in 1970 could not be resold to out-of-state residents without registration in 1973 because they "represent an unsold allotment of an intrastate offering."

¹³¹ See 1 Loss 299-300. Under § 2(3) of the Act, 15 U.S.C. § 77b(3) (1970), immediately exercisable stock options or warrants constitute continuing offers of the underlying securities.

¹³² Since a warrant constitutes a security under article 8 of the UNIFORM COMMERCIAL CODE, the issuer must comply with the terms of the instrument and may be required to deliver the underlying security to the holder of the warrant. See §§ 8-202(1) & 8-314(2).

¹³³ Even with this degree of advance planning, things can still go wrong. The author is aware of one situation where the issuer took elaborate steps to protect against the exercise of intrastate warrants by nonresidents over the five-year life of the warrants. Then a few years after the offering, for sound corporate reasons, the issuer changed its corporate domicile by merging into a Delaware subsidiary, thereby unwittingly destroying the exemption for the outstanding warrants since the issuer was no longer a resident of the same state as the offeree warrant holders.

¹³⁴ See note 166 *infra* and accompanying text.

¹³⁵ 15 U.S.C. § 77b(3) (1970) provides:

The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell," "offer for sale,"

utory exemption for the conversion of convertible securities is a sufficient basis for viewing the conversion of convertible securities differently from the exercise of options and warrants.¹³⁶ As a result, convertible securities originally sold in a valid intrastate offering can, after the issue has "come to rest," be resold to and converted by nonresidents without loss of the exemption. Rule 147 reaffirms the substance of this interpretation.¹³⁷

An often perplexing question, and one that is not answered by rule 147, is presented by the intrastate sale of securities on an installment purchase basis to a purchaser who changes his state of residence prior to completion of his payments. The issue is whether a new sale is effected for purposes of § 3(a)(11) each time a payment is made by the nonresident, or the payment is merely in partial payment for a single, mutually enforceable sale of the entire amount of the securities subject to the agreement. This in turn should depend on whether the purchaser in effect is making a new investment decision to buy or not buy with each payment, having the legal or practical right to do so without significant consequence under the terms of the purchase agreement. For example, if the purchase agreement were severable or separable in that a separate purchase and sale occurred with each payment, or if it contained provisions the effect of which were to allow the purchaser to cease making payments and retain some guaranteed portion of the securities he contracted to buy, then the arrangement might be deemed a series of sepa-

or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 77e of this title shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer). Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security.

¹³⁶ SA Rel. 4434 provides: "Also, reliance should not be placed on the exemption for an issue which includes warrants for the purchase of another security unless there can be assurance that the warrants will be exercised only by residents. With respect to convertible securities, a section 3(a)(9) exemption may be available for the conversion."

¹³⁷ See notes 190-192 *infra* and accompanying text.

rate sales and the exemption would be lost.¹³⁸ On the other hand, if the arrangements were such that the *issuer* had the right, but not the obligation, to terminate the sale upon default in payment and withhold delivery of the balance of the securities or demand their return if previously delivered, this right alone should not affect an otherwise valid exemption since the nonresident investor does not have the right to make a new investment decision with each payment obligation and the stated remedies would no doubt be available to the issuer, at least as a practical matter, in any event.

D. *Resales to Nonresidents*

When and under what circumstances can securities offered and sold under the intrastate exemption be reoffered and resold to nonresidents? The express terms of § 3(a)(11) provide no guidance, as all that is specifically required is that the entire issue be "offered and sold to persons resident within a single State or Territory." Since the Act is addressed to the distribution of securities, and requires registration of securities in distribution unless expressly exempt therefrom, the intrastate exemption is not available unless the entire issue has been distributed solely to residents of the state of the issuer's residency. In other words, the intrastate issue must have "come to rest" solely in the hands of residents before reoffers and resales to nonresidents may commence.¹³⁹ As a minimum then, reoffers and resales to nonresidents may not be effected while the intrastate offering is in progress.

Theoretically, at least, the issue could come to rest, and resales to nonresidents could begin, as soon as all the securities had been sold to resident investors.¹⁴⁰ It would be a frustration of § 3(a)(11), however, to permit resales to nonresidents, or the development of an interstate market, immediately after the sale of all the securities to residents if such sale were merely the first step in an ultimate plan of multi-state distribution. The reported administrative cases and court decisions are replete with examples denying the exemption where the reoffers and resales by the resident buyers established or strongly inferred a plan of distribution beyond the residents of a single state, particularly where the initial resi-

¹³⁸ See Hertz, *supra* note 10, at 302-03; McCauley, *supra* note 10, at 946.

¹³⁹ As early as 1934, the Commission alluded to the "come to rest" theory in its statement: "It is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of investors resident within the state." SA Rel. 201. See also SA Rel. 1459, Brooklyn Manhattan Transit Corp., 1 SEC 147 (1935); SEC v. Hillsborough Invest. Corp., 173 F. Supp. 86 (D. N.H. 1958).

¹⁴⁰ See Wander, *Review of "Business Organizations—Securities Regulation,"* 23 BUS. LAW. 1237, 1238-39 (1968).

dent buyers were either underwriters, dealers, or in some way affiliated with the issuer.¹⁴¹

Since the concept of intrastate versus interstate distribution carries with it the element of the subjective intent of the issuer and resident purchasers, the Commission has long attempted to resolve the question by examining post-offering facts as evidence of the presence or absence of such intent:

This is not to suggest, however, that securities which have actually come to rest in the hands of resident investors, such as persons purchasing without a view to further distribution or resale to nonresidents, may not in due course be resold by such persons, whether directly or through dealers or brokers, to nonresidents without in any way affecting the exemption. The relevance of any such resales consists only of the evidentiary light which they might cast upon the factual question whether the securities had in fact come to rest in the hands of resident investors. If the securities are resold but a short time after their acquisition to a nonresident this fact, although not conclusive, might support an inference that the original offering had not come to rest in the State, and that the resale therefore constituted a part of the process of primary distribution; a stronger inference would arise if the purchaser involved were a security dealer.¹⁴²

As a result of the Commission's position based on the intent of the purchaser, it became the common practice in intrastate offerings to: (1) obtain representations and covenants from purchasers that they were bona fide resident domiciliaries of the state, were purchasing the securities for their own account with no intent to reoffer or resell them to nonresidents of the state, and that no sale or other transfer would be made to a nonresident during the course of the offering and thereafter unless the securities were then registered under the Act or the issuer had received an opinion of counsel to the effect that such resale would not cause the intrastate exemption to be lost; (2) include a legend on the certificate representing the security reflecting the substance of the transfer restrictions; and (3) issue stop transfer instructions to the issuer's transfer agent.¹⁴³ Many issuers would not specify a time period following the completion of the offering during which such restrictions

¹⁴¹ *E.g.*, *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957) (issuance to broker who transferred sixty percent of shares to out-of-state purchasers); *Capital Funds, Inc. v. SEC*, 348 F.2d 582 (8th Cir. 1965) (sale to salesman of broker-dealer followed by resale within days to non-resident); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir. 1970) (finding that broker-dealer knew or should have known purchasers, after commencement of trading in the stock, were nonresidents).

¹⁴² SA Rel. 4434. SA Rel. 1459 contains substantially identical language and concludes that an inference that the original purchase was not for investment "would naturally be created if the seller were a security dealer rather than a non-professional."

¹⁴³ See 31 OHIO ST. L.J., *supra* note 10, at 536-38.

on transfer would be in effect, for to do so might imply a prohibited present intent to resell to nonresidents at some future time. Most counsel, however, would render the necessary opinion, other factors being equal, after approximately one to two years, or simply advise the issuer to waive the opinion condition after that time.

Until the advent of rule 147, the Commission had not officially designated any time period following the completion of the offering after which residents could safely resell to nonresidents.¹⁴⁴ Providing much needed clarity to this question, rule 147 prohibits reoffers and resales to nonresidents during the course of the offering plus an additional nine months thereafter.¹⁴⁵ The Commission will no doubt apply this standard in non-rule transactions, at least in situations not involving a clear preconceived plan for a deferred interstate distribution. Moreover, since the rule's approach is both pragmatic and a reasonable attempt to carry out the statutory objectives, it probably also will provide an acceptable benchmark to the courts. The reported cases dealing with the resale question generally have involved offerings distributed by securities dealers with resales to nonresidents occurring either during the course of the offering or so close to its purported "completion" that it had been relatively easy to conclude the resales were a part of the original distribution.¹⁴⁶ The courts have not been called upon to respond to the more difficult question presented by isolated resales to nonresidents a few months after the original offering. Although it is likely that the courts will give great weight to the rule's nine-month limitation in such non-rule transactions, it should still be possible to argue persuasively that, in view of all the facts and circumstances, the offering had come to rest in-state and the questioned resale to a nonresident was made without a prior intent to do so at the time of the initial purchase.¹⁴⁷

¹⁴⁴ In *Brooklyn Manhattan Transit Corp.*, 1 SEC 147, 162-63 (1935), the Commission, in dicta, suggested that the one-year period during which securities were presumed to be in distribution under the dealer exemption contained in the third clause of § 4(1) of the Act as then in effect could serve as a basis for a rebuttable presumption that an offering comes to rest after one year for purposes of § 3(a)(11). The Commission has not subsequently reaffirmed a rebuttable presumption of any duration, certainly not the forty-day period substituted in 1954 for the one year period of the dealer exemption now contained in § 4(3). See notes 35-37 *supra* and accompanying text, for a discussion of the broker and dealer exemptions and their relationship to the intrastate offering exemption.

¹⁴⁵ Rule 147(e). See notes 187-189 *infra* and accompanying text.

¹⁴⁶ See note 141 *supra* and cases cited. See also *SEC v. Hillsborough Investment Corp.*, 173 F. Supp. 86 (D. N.H. 1958), where resales occurred within twenty to thirty days after initial sale; *Belhumeur v. Dawson*, 229 F. Supp. 78 (D. Mont. 1964), where resale to nonresident occurred immediately after sale to resident.

¹⁴⁷ In a no-action letter, *Space Corporation*, '70-'71 CCH DEC. ¶ 78,096 (1971), the Commission's staff concluded that "[a]lthough the availability of an exemption is not free from doubt," it would recommend no action if \$422,000 of debentures received for the sale of a business in a transaction exempt under § 3(a)(11) were resold under § 4(1)

It is largely because of the prohibitions on interstate resales of securities issued in intrastate offerings that the exemption has been of marginal utility in offerings relying on the distributive efforts of securities underwriters and dealers.¹⁴⁸ Rule 147, with its nine-month resale prohibition, does little to restore this lack of utility. As a result, it will be impossible to institute an interstate trading market after the offering, whether it be under rule 147 or otherwise,¹⁴⁹ and an intrastate market is

of the Act without registration. The parties requesting the no-action letter had originally purchased the debentures in 1967 and had suffered adverse business and personal developments in the period between the purchase of the debentures and their proposed sale. The staff appears to have reluctantly concluded that these debentures had "come to rest" prior to their resale, but still required an opinion of counsel that the resale would be exempt from registration.

¹⁴⁸ SA Rel. 4434 concluded:

Consequently, any dealer proposing to participate in the distribution of an issue claimed to be exempt under section 3(a)(11) should examine the character of the transaction and the proposed or actual manner of its execution by all persons concerned with it with the greatest care to satisfy himself that the distribution will not, or did not, exceed the limitations of the exemption. Otherwise the dealer, even though his own sales may be carefully confined to resident purchasers, may subject himself to serious risk of civil liability under section 12(1) of the Act for selling without prior registration a security not in fact entitled to an exemption from registration.

See also Gadsby, *The Securities and Exchange Commission and the Financing of Small Businesses*, 14 BUS. LAW. 144, 146 (1958) where the author, who was then chairman of the Commission, stated that the exemption, "due to practical considerations, is primarily an exemption for small issues for the simple reason that the offering and sale of a large issue is very apt to fail to meet all of the terms and conditions of the exemption."

¹⁴⁹ See Securities Act Release No. 4386 (Jul. 12, 1961) CCH FED. SEC. L. REP. § 76,774 ('57-'61 Transfer Binder), in which the Commission, in an effort to clarify the § 3(a)(11) exemption, stated:

Not only the original sale but any further transactions effected as part of the process of distribution to the public must be limited to residents. It should be emphasized, therefore, that the exemption is not necessarily available simply because initial sales are confined to residents of the state. If any person, whether or not a professional underwriter or dealer, purchases the securities offered with a view to resale and does, in fact, resell them to non-residents, such person may be a statutory underwriter engaged in transactions forming a part of the distribution to investors. Where, as a result of such a chain of transactions, the process of distribution is not completed prior to the time the securities are acquired by non-residents, the exemption is not available to the issuer or to any other person participating in the distribution.

In the type of offering discussed above, the quick commencement of trading and prompt resale of portions of the issue to non-residents raises a serious question whether all of the issue has, in fact, come to rest in the hands of investors resident in the state of initial offering. Where these practices are followed, it is likely that portions of the issue will be offered or sold to nonresidents through residents and dealers purchasing for resale and thus constitute elements of the distribution to investors. If so, in view of the considerations outlined above, exemption under Section 3(a)(11) is not available and the entire issue will have been offered and sold in violation of the Securities Act. Such an illegal distribution may not only subject the participants to enforcement action by the Commission, but subjects them also to civil liability for damages or rescission under Section 12 of the Securities Act of 1933. (footnotes omitted).

See generally Sosin, *supra* note 10, at 120-21.

both less desirable and more difficult to police. In an underwritten offering, one of the features normally attractive to the investors and underwriters is the prospect of a trading market following the offering, and such investors generally are not concerned about state lines (in fact, their trading is usually effected through the dealer from whom they originally purchased the securities). Limitation of the aftermarket to the state of issue for a substantial period of time naturally reduces the scope and effectiveness of the trading, since most markets are generally maintained in wholesale, over-the-counter trading between dealers of various states.¹⁵⁰ This limitation also places, as a practical matter, a virtually impossible or unacceptable burden on the dealer's salesmen to check the residency credentials of each prospective trading market buyer. Even if the salesman is conscientious about his responsibility, his control is virtually lost when the buyer is another brokerage house buying in street name on behalf of an unidentified buyer. Moreover, as we have seen,¹⁵¹ an underwriter or dealer is subjected to liability from loss of the exemption not only as a result of its own disqualifying acts, but those of others as well, including the issuer, other dealers, and purchasers of the securities.

III. RULE 147—SPECIFIC PROVISIONS AND OPERATION

A. *General Considerations*

Rule 147 was adopted by the Commission on January 7, 1974 in Securities Act Release No. 5450, and is effective for issues of securities commenced on or after March 1, 1974.¹⁵² Release 5450 contains a comprehensive explanation of the rule, and is helpful in providing insights to the Commission's interpretation and application of the rule. It should be reviewed as a part of any analysis of the rule.

The rule itself consists of four "preliminary notes" and six operational subparagraphs: (a) the transactions covered by the rule, (b) what constitutes a "part of an issue," (c) the nature of the issuer, including residency and doing business in the state, (d) residency of offerees and purchasers, (e) resales to nonresidents, and (f) required precautionary steps against prohibited resales.

The first preliminary note provides that the rule is not the exclusive

¹⁵⁰ See Sosin, *supra* note 10, at 117-18.

¹⁵¹ See notes 29-30 *supra* and accompanying text.

¹⁵² The rule and its benefits cannot be applied retroactively, and intrastate offerings commenced prior to March 1, 1974, even if continued after that date, cannot rely on the rule. See the Commission's response to the no-action request in North American Acceptance Corporation (available February 18, 1974).

means of complying with § 3(a)(11), and the failure to satisfy all the provisions of the rule does not necessarily mean the exemption is not available. The Commission, however, will not be of much assistance in determining whether and to what extent the substantive provisions of the rule will be applied to non-rule offerings, since the Commission has announced it will respond to no-action letter requests involving non-rule transactions "only on an infrequent basis and in the most compelling circumstances."¹⁵³

Preliminary note 2 confirms that the rule does not supersede or obviate the need to comply with the applicable state securities laws.

The third preliminary note briefly discusses the history and purpose of the rule, notes its main provisions, places the burden of proving compliance with the rule and § 3(a)(11) on those who seek to rely on the exemption, limits the exemptive relief only to the registration requirements of § 5, and, finally, warns "the rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities." As to this caveat, Release 5450 gives as an example of such a scheme a series of offerings by affiliated organizations in several states if what is being financed is in effect a single business enterprise.¹⁵⁴

The last preliminary note makes it clear that the rule is not available for non-issuer, or "secondary" transactions, but that controlling persons can rely on § 3(a)(11) if it would then have been available to the issuer under applicable judicial and administrative interpretations.¹⁵⁵

Rule 147(a) is the link with § 3(a)(11), providing that offers and sales by an issuer of its securities made in accordance with *all the terms and conditions* of the rule shall be deemed a transaction within the statutory exemption. This subparagraph requires full and complete compliance, not just a good faith or substantial compliance. Since the rule is laced with highly technical requirements and inflexible quantifications, the slightest deviation, however minor, will render the rule unavailable. It also means that an offering not meeting all of the provisions of the rule may not rely on selected provisions of the rule that it does satisfy, and on current judicial and administrative interpretations as to the other ele-

¹⁵³ SA Rel. 5450. On the other hand, the Commission in the release did express a willingness to provide interpretative letters to assist persons in complying with the rule.

¹⁵⁴ Prior examples of such schemes appear in the cases cited in notes 63 & 83 *supra*. But see notes 84-86 *supra* and accompanying text, regarding an anticipated Commission position that it will not integrate offerings by distinct partnerships solely because of the existence of a common general partner.

¹⁵⁵ See note 119 *supra* and accompanying text, regarding the availability of the exemption in "secondary" intrastate offerings.

ments of the exemption. It may well be that such an offering would qualify for the exemption (since, as we have seen, the courts may not find it necessary to apply all of the rule's provisions to non-rule transactions),¹⁵⁶ but all of its elements must be tested under the then-existing judicial and administrative interpretations, exclusive of the rule. This distinction most likely will be of more practical significance in underwritten intrastate offerings. Since the prime benefit of the rule is the degree of certainty of compliance with § 3(a)(11) that accompanies transactions meeting the standards of the rule, cautious underwriters may well refrain from undertaking those offerings where counsel is unable to render an unqualified opinion to the effect that rule 147 is available. Even if counsel were able to render an opinion that the exemption is available under non-rule law, many underwriters may still decline, unless the deviations from the rule's standards were nominal.¹⁵⁷

B. *Part of an Issue*

Rule 147(b)(1) incorporates the "part of an issue" or "integration" element of the exemption that has long been a part of its interpretation by providing that "all securities of the issuer which are part of an issue shall be offered, offered for sale or sold in accordance with all the terms and conditions of this rule."¹⁵⁸ Contrary to the other major interpretive elements of the exemption for which it provides objective standards, rule 147 does not attempt to define or clarify "part of an issue" other than to provide that a limited group of offers and sales will not be deemed integrated. Thus the current judicial and administrative interpretations must be applied on a case-by-case basis, since the rule offers no additional guidelines other than to restate without elaboration the Commission's same five integration factors set forth in the 1961 release.¹⁵⁹

As first proposed in January 1973, the rule would have integrated all securities (other than those exempt under § 3(a)) offered or sold by the issuer, its affiliates and its predecessors within any consecutive six-month period, the implication being that other offers and sales would

¹⁵⁶ See note 9 *supra* and accompanying text.

¹⁵⁷ An underwriter's reluctance to accept an opinion is not unreasonable. As broker-dealers, underwriters are engaged in what is basically an industry regulated by the Commission under the Securities Exchange Act of 1934, and cautious underwriters naturally may hesitate to deviate from the Commission's clear guidelines contained in rule 147. See notes 26-40 *supra* and accompanying text, regarding the liabilities and sanctions to which underwriters are subject.

¹⁵⁸ Rule 147(b)(1).

¹⁵⁹ Rule 147, Preliminary Note 3 and SA Rel. 5450 specifically state that a case-by-case determination will continue to be necessary. See note 72 *supra* and accompanying text, listing the five integration factors.

not be integrated.¹⁶⁰ On reconsideration, the Commission found this approach unnecessarily restrictive, and in the final rule abandoned it in favor of incorporating the existing law and providing a limited "safe harbor" where certain prior and future offers and sales will not be deemed a part of the proposed intrastate issue to be effected under the rule.¹⁶¹ This limited protection is available only for offerings made under the rule, and is intended to have no applicability or influence in non-rule transactions.

Under the safe harbor provisions of rule 147(b)(2), "an issue shall not be deemed to include any offers or sales of securities of the issuer" made "prior to the six-month period immediately preceding or after the six-month period immediately following any offers or sales pursuant to" rule 147, provided that each of the following conditions is met: (1) the securities offered and sold outside the dual six-month "clean" period were effected either pursuant to a registration statement filed under the Act or pursuant to the private offering exemption under § 4(2) or pursuant to any of the exemptions under § 3; and (2) during the clean period there were no offers or sales by or for the issuer of securities of the same or similar class as those offered or sold pursuant to the rule. If these conditions are met, then securities offered and sold either before or after the clean period will not be deemed part of the issue offered and sold pursuant to the rule. However, all securities offered or sold during the clean period, whether or not of the same class, are not protected by the safe harbor provisions, and whether or not they are integrated with the rule 147 offering must be determined under the then-prevailing judicial and administrative interpretations.¹⁶² If these conditions are not met, the availability of the rule to the offering is not thereby automatically destroyed but the safe harbor protection is lost, and the question of integration with respect to *all* prior and future offers and sales (whether within or without the clean period) must be determined on a case-by-case basis under such judicial and administrative interpretations.

The safe harbor provisions represent a brief but complex piece of draftsmanship that well may engender interpretive questions and practical difficulties of a degree commensurate with those they attempt to resolve. Initially, it may be difficult to determine the clean period during which offers or sales of the same or similar class are restricted. It is clear, at least, that the period will normally be in excess of twelve months, since it would be expanded in the middle to include the time during

¹⁶⁰ SA Rel. 5349.

¹⁶¹ SA Rel. 5450.

¹⁶² Rule 147, Preliminary Note 3.

which the primary intrastate issue was being offered and sold pursuant to the rule. It is not clear whether this means only the time during which the securities are being offered and sold by the issuer, or some vague additional period akin to the "coming to rest" period defined as nine months under the rule's resale provisions.¹⁶³ The answer probably lies somewhere in between, such as the entire period during which the selling or marketing effort takes place, including that by the issuer, any of the underwriters or participating dealers, or any other selling agent or intermediary. To provide greater certainty in establishing the beginning of the second six-month period, issuers and underwriters may find it appropriate to take some formal action to evidence the actual termination of the marketing effort—perhaps a most difficult task for the underwriter in a slow moving, firm-commitment underwriting where the underwriter retains an unsold balance it can only sell in small amounts from time to time.

The limitation of relief from integration to offers and sales of securities registered or exempt under the Act imposes an additional burden on those seeking to rely on the safe harbor provisions, particularly underwriters who may not be in as good a position as the issuer to assess the validity of a prior claimed exemption. Although there is seemingly little relationship between the lawfulness of a prior offering and the question of integration, the Commission in a similar manner has previously utilized such conditions to exemptive relief as a method of enforcing the registration requirements.¹⁶⁴ Be that as it may, reliance upon the safe harbor rule will necessitate a careful legal review of prior offers and sales, and, in underwritten offerings at least, will normally require the confirming opinion of issuer's counsel. It could even lead to the circular dilemma in which a prior private offering was effected in full compliance with § 4(2) but under circumstances where it probably would be integrated with a proposed public intrastate offering seven months later. Because the § 4(2) exemption would then be lost, a literal reading of rule 147(b)(2), since it applies only for purposes of rule 147, would render the safe harbor provisions inapplicable with respect to the prior private offering—a result that renders the safe harbor provi-

¹⁶³ Rule 147(e).

¹⁶⁴ *E.g.*, Rule 254(a)(i), Reg. § 230.254(a)(1), 1 CCH FED. SEC. L. RPT. ¶ 2362, providing that securities sold by the issuer within one year prior to a proposed Regulation A offering "in violation of section 5(a) of the Act" will be integrated with the securities to be sold under Regulation A for purposes of computing the \$500,000 limitation. See also Proposed Rule 238, Securities Act Release No. 5444 (Dec. 13, 1973), Reg. § 230.238, 1 CCH FED. SEC. L. RPT. ¶ 2358B, exempting certain options from the registration requirements of the Act if the gross proceeds from the sale thereof and *unregistered* "related options" does not exceed \$500,000.

sions a nullity with respect to prior or future offerings relying on exemptions having their own integration problems.¹⁶⁵

The safe harbor protections can be lost automatically as a result of offers or sales of the same class during the clean period even if they would not be integrated with the proposed intrastate offering under current judicial and administrative interpretations. While this result is insignificant with respect to those offers and sales, it may place in doubt the availability of § 3(a)(11) for the intrastate offering if exclusive reliance is placed on the safe harbor provisions with respect to the integration of other prior or proposed offers and sales. Such a loss of the safe harbor protections may readily occur in intrastate common stock offerings, as many issuers are likely to offer or sell common stock during a clean period with a duration in excess of twelve months as a result, for example, of any one or more of the following unrelated, but not atypical, instances: (1) the exercise or grant or mere existence of any stock options or warrants;¹⁶⁶ (2) sales of common stock pursuant to any other employee incentive or retirement plan; or (3) the merger, consolidation, or acquisition of assets involving the issuance of common stock by the issuer.¹⁶⁷

The safe harbor provisions are fraught with sufficient pitfalls to render reliance on them risky at best for most offerings. This is particularly true of underwritten offerings in which the underwriter has little practical control over prior or future events, notwithstanding its ability to obtain warranties and indemnification covenants from the issuer.¹⁶⁸

C. *Doing Business*

Rule 147(c) requires the issuer to be doing business in the state or territory at the time of all offers and sales. Subsection (c)(2) provides that the issuer will satisfy the doing-business requirement if it meets four conditions regarding (1) the amount of the issuer's gross revenues

¹⁶⁵ The exemptions provided by §§ 4(2) and 3(a)(9), 15 U.S.C. §§ 77d(2) & c(a)(9) (1970), also incorporate the integration concept. See note 65 *supra* and accompanying text.

¹⁶⁶ See note 131 and accompanying text.

¹⁶⁷ It is less likely that debt offerings made pursuant to the rule 147 exemption will be integrated with prior or subsequent debt offerings to cause a loss of the safe harbor provisions, provided the terms of the debt securities are not substantially identical. In one case involving a debt offering, *SEC v. Dunfee*, '66-'67 CCH DEC. § 91,970 (W.D. Mo. 1966), the district court concluded that seven percent notes, payable in 36 months, were a new issue of securities that could not be integrated with six percent notes, payable in twenty monthly installments, which had been issued by Mr. Dunfee approximately nine months earlier. The district court reviewed the cases involving the integration of equity offerings and found that those cases "differ greatly" from the situation where debt instruments with different interest rates and maturity periods are offered.

¹⁶⁸ See note 32 *supra* and accompanying text.

derived from in-state operations, (2) the amount of its consolidated total assets located in the state, (3) the amount of the proceeds of the offering applied to the conduct of its in-state business, and (4) the location of its principal office. With respect to the latter requirement, the issuer's principal place of business must at all times during the offering be in its state of residency.

Under the gross revenues standard, the issuer must have derived, during the applicable measuring period, "at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis . . . from the operation of a business or of real property located in or from the rendering of services within such state or territory."¹⁶⁹ The appropriate measuring period depends on when during the issuer's fiscal year "the first offer of any part of the issue is made."¹⁷⁰ If it is made during the first six months of the current fiscal year, the measuring period is the most recently completed fiscal year. If the first offer is made during the last six months, the issuer may elect as the measuring period either the first six months of that fiscal year or a consecutive twelve-month period consisting of the last six months of the last fiscal year and the first six months of the current fiscal year. The moving twelve-month period recognizes the seasonal character of some businesses and permits them to calculate gross revenues on the basis of a full operational cycle. The gross revenues test does not apply to any issuer which has not had more than \$5,000 of gross revenues during "its most recent twelve-month fiscal period."¹⁷¹ Presumably this means the twelve-month period ending with the first month prior to the month in which occurs the first offer of any part of the intrastate issue, although the rule is silent as to the beginning and end of that measuring period.

Examples of activities that qualify as in-state business are contained in Release 5450, and they suggest the Commission has adopted a reasonable and pragmatic approach concerning the nature of qualifying businesses. These examples indicate that the Commission will not deem revenues disqualified solely because they are from the sale of products or rendering of services to out-of-state customers if the products and services are sold or rendered from an in-state principal office and operational center and no sales personnel or employees are located outside the state.

¹⁶⁹ Rule 147(c)(2)(i).

¹⁷⁰ The use of the phrase "any part of the issue" requires a determination to be made regarding the possible integration of prior offers. If a prior, "integratable" offering had been commenced in a fiscal period earlier than the one in which the proposed offering is to be made, a literal reading of rule 147(c)(2)(i) would specify the earlier measuring period, and could cause the issuer to fail to meet the eighty-percent test on the basis of stale data not necessarily representative of the issuer's present sources of gross revenues.

¹⁷¹ Rule 147(c)(2)(i).

Although these examples provide some indication of the manner of the Commission's future interpretation of the gross revenues and other doing-business standards, they cannot respond to the virtually limitless factual variations, which, hopefully, will provide the Commission with sufficient incentive to further clarify the doing-business standards through interpretive releases and published responses to no-action letters.¹⁷²

To satisfy the gross assets test, the issuer must have "had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within such state or territory."¹⁷³ Although no guidance is provided in the rule, presumably the Commission intends the standard to be eighty percent *in value* of the issuer's assets as shown on the appropriate balance sheet. As assets are normally valued at the lower of market or cost less depreciation under generally accepted accounting principles, a difficult interpretive question arises when certain out-of-state assets carried at a low cost, such as real property, may have appreciated in value to the point where they represent more than twenty percent of total assets on a market value basis. Until clarified by the Commission, issuers should also calculate the assets test on an estimated fair market value basis and be reluctant to rely on rule 147 where such calculation discloses out-of-state assets having a value materially in excess of twenty percent of total assets.

Determination of the state of location may also present difficulties in the case of certain ownership interests and intangible assets, such as investment securities, accounts and notes receivable and other claims, good will, patents, trademarks and copyrights, and capitalized research and development costs. Investment securities would probably be located at the principal office of the issuer, unless the security in effect represented an undivided interest in specific property (such as a partnership interest in a partnership having as its only asset an out-of-state real estate project or operating out-of-state oil and gas wells). In an example contained in Release 5450, the Commission states that "accounts receivable arising from a business conducted in the state would generally be considered to be located at the principal office of the issuer." A similar conclusion would be appropriate for other intangible assets, although issuers should be wary when intangibles, such as good will and research and develop-

¹⁷² See note 153 *supra* and accompanying text regarding the Commission's unwillingness to respond to no action letter requests regarding transactions under rule 147.

¹⁷³ This standard is virtually without precedent in the pre-rule cases and releases. See note 103 *supra* and accompanying text. Again, the use of the phrase "any part of the issue" raises the spectre of integration and the resulting use of an out-of-date measuring period unrelated to the current location of the issuer's assets. See note 170 *supra*.

ment costs, are of sufficient magnitude to increase total assets to the point where the relationship of out-of-state tangible assets to in-state tangible assets are distorted materially beyond a 20/80 ratio.¹⁷⁴

The application of the asset standard could in many situations preclude use of the rule by genuinely local businesses. Businesses with a relatively small amount of tangible assets and low receivable balances, such as some service organizations and selling agencies, may find satisfaction of the asset test particularly difficult. For example, an Ohio computer service bureau may have considerably more than twenty percent of its assets invested with others in the joint ownership of a computer located in Michigan; or a Pennsylvania business consulting firm, or manufacturer's representative, or distributor selling on consignment, may have more than twenty percent of its assets committed to a passive investment in real property located in Arizona. In each of these situations, the rule's doing-business test would not be satisfied, even if all operations and services were conducted and all customers were located in the issuer's state of residency.

Issuers with subsidiaries that do not prepare their financial statements on a consolidated basis will be required to obtain comparable financial information for purposes of calculating the gross revenues and assets limitations. Such consolidated results are of obvious significance when an issuer's out-of-state activities are conducted by unconsolidated subsidiaries. Presumably, consolidation is to be in accordance with generally accepted accounting principles recognized by the Commission for financial statements contained in registration statements filed under the Act.¹⁷⁵ Accordingly, where consolidation is not so required with respect to certain less than wholly-owned subsidiaries, the Commission should not require their consolidation solely for purposes of the rule unless the ab-

¹⁷⁴ For example, a Colorado company in the developmental stage of extracting oil from shale could have as its principal assets lease rights to shale reserves located in Colorado carried at \$100,000, \$400,000 of capitalized research and development costs, and \$25,000 of miscellaneous tangible assets. If the company also owned lease rights to shale reserves in an adjoining state carried at \$50,000, its balance sheet would indicate approximately ninety-one percent of its total assets to be located in Colorado, although only sixty-eight percent of its operating assets would be located within that state. Had the research and development costs been expensed, the company would not meet the assets test of rule 147(c)(2)(ii).

¹⁷⁵ The Commission's general requirements for financial statements to be included in registration statements are contained in Regulation S-X, 17 C.F.R. Part 210, 4 CCH FED. SEC. L. RPTR. ¶ 69,101 *et seq.* Article 4 of Regulation S-X, 17 C.F.R. §§ 210.4-01-4-09, 4 CCH FED. SEC. L. RPTR. ¶ 69,191-69,226 sets out specific requirements for consolidated financial statements. See Reg. § 210.4-06, 17 C.F.R. § 210.4-06, 4 CCH FED. SEC. L. RPTR. ¶ 69,210, regarding the elimination of intercompany items and transactions between the parent and the consolidated subsidiary.

sence thereof results in a materially distorted representation of the issuer as a local enterprise.¹⁷⁶

Under the third standard, the issuer fails to meet the doing-business requirement unless "it intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory."¹⁷⁷ Interpretive questions, similar to those arising under the gross revenues test, are also present here regarding the nature of the activities that qualify as in-state business operations. Additionally, what if the proceeds are to be applied in repayment of outstanding indebtedness to an out-of-state lender? The mere fact that the proceeds are to be sent out-of-state in repayment of a loan should not disqualify the offering under the rule any more than should the use of the proceeds to purchase local real estate from an out-of-state vendor. However, an issuer should be prevented from doing indirectly that which it could not do directly. For example, the application of more than twenty percent of the offering proceeds to repay a short-term loan recently incurred to finance an out-of-state operation may be an example of what the Commission had in mind when it said, in the rule's third preliminary note: "The rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such persons to make interstate offers or sales of securities." Under this example, it would make no difference whether the lender was located within or without the state.

D. *Residency*

(1) Of the Issuer

Rule 147(c)(1) provides that an issuer shall be deemed a resident of the state or territory in which (i) "it is incorporated or organized, if it is a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law," or (ii) in which "its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law."¹⁷⁸ The syntax of these clauses raises a question as to the residency of a general partnership. Since most general partnerships are organized under a specific state law, a general partnership should

¹⁷⁶ 17 C.F.R. 210.4-02(a)(1), 4 CCH FED. SEC. L. RPT. ¶ 69,193, provides that the registrant shall not consolidate any subsidiary which is not majority owned.

¹⁷⁷ Rule 147(c)(2)(iii). See notes 109 & 110 *supra* and accompanying text.

¹⁷⁸ Rule 147(c)(1)(i)-(ii).

fit under clause (i) and its state of organization would be its state of residency. However, "general partnership" is conspicuously absent from the listing of entities in clause (i), but is specifically named in clause (ii), thereby indicating that its place of residency is the state or territory where its principal office is located. If the clause (ii) phrase "not organized under any state or territorial law" is intended also to modify "general partnership," then the residency of general partnerships organized under a specific state statute would be determined by the state of organization like any other statutory form of business organization. The latter seems the preferable interpretation, particularly in light of the Commission's statement in Release 5450 that all business entities, including general partnerships, should be treated in a similar manner.¹⁷⁹

The residency of an individual who is deemed an issuer (*e.g.*, a promoter issuing pre-incorporation certificates, or undivided fractional oil and gas interests) is the state where his principal residence is located. Although the Commission cautioned against "temporary residence" in the context of offerees and purchasers,¹⁸⁰ this concept well may be applied to confine to a single state nomadic individual issuers of oil and gas interests or sundry forms of investment contracts.

(2) Of Offerees and Purchasers

Rule 147(d)(1) provides that for purposes of determining the residence of offerees and purchasers, a "corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory."¹⁸¹ The state of incorporation or organization is irrelevant, as location of the principal office is the only test of residency of an offeree business organization. It appears that the Commission has carefully chosen "principal office," as opposed to some other term such as "principal place of business," to avoid any

¹⁷⁹ In SA Rel. 5450, the Commission stated:

As initially proposed, the rule provided that in a partnership, *all* the general partners must be resident within such state or territory. The Commission has reconsidered this provision in light of the provisions applicable to corporations and determined to treat all business entities in a similar manner.

The author's conclusion that the residency of a general partnership organized under a specific state statute should be its state of organization is not unanimous. Professor Hugh Sowards has arrived at the opposite conclusion, stating, "As adopted, the rule looks to the site of the principal office of the partnership rather than the residence of the individual partners." Sowards, *Rule 147, REV. SEC. REG. 972* (1974).

¹⁸⁰ In SA Rel. 5450, the Commission specifically stated that the temporary residence of an offeree or purchaser would not satisfy the residency requirements of rule 147(d). See notes 121-124 *supra* and accompanying text.

¹⁸¹ Rule 148(d)(1).

necessity of determining the amount or character of the offeree's in-state business activities akin to that required under the doing-business tests applicable to issuers.

This general test for a business organization is qualified to the extent that if it "is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule [it] shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory."¹⁸² This codifies what most securities practitioners have deemed the law to be, and further confirms that the Commission's concept of "beneficial ownership" will be applied, thereby requiring inquiry far beyond the record ownership of the interests in the newly-formed purchaser.¹⁸³

An individual offeree or purchaser "shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory."¹⁸⁴ The determination of an individual's principal residence will be difficult where two or more residences are maintained and the individual spends an approximately equal amount of time at each location. In such a case, the determination will depend on additional factors, similar to those associated with the ascertaining of "domicile," such as location of personal assets, place of voting, extent of involvement in the community, place where licensed to drive automobiles, and the nature of ownership of the residences. Principal residence, however, does not necessarily depend on the amount of time normally spent at a particular location. For example, an unmarried college student may have several campus residences during the course of his education, but his principal residence, absent other factors, will be the principal residence of his parents. The elusive residence status of students and military personnel is probably a prime motivating factor for the Commission's caveat against relying on an offeree-purchaser's "temporary residence."¹⁸⁵

E. *Resales to Nonresidents*

With respect to resales, rule 147(e) provides that "during the period

¹⁸² Rule 147(d)(3).

¹⁸³ See generally Securities Exchange Act Release 7793 (Jan. 19, 1966), 2 CCH FED. SEC. L. RPT. ¶ 26,031, and Securities Exchange Act Release 7824 (Feb. 14, 1966), 2 CCH FED. SEC. L. RPT. ¶ 26,030, issued by the Commission to "restate and clarify" the meaning of "beneficial ownership of securities" under the Federal securities laws when securities are held in the name of family members or other affiliates. For a general discussion of these releases by the then Executive Assistant Director, Division of Corporation Finance, see Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAW. 431 (1967).

¹⁸⁴ Rule 147(d)(2).

¹⁸⁵ See note 180 *supra*.

in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory."¹⁸⁶ It should be noted that only resales, not reoffers, are prohibited.

The determination of the restricted period may be a most difficult assignment. Initially, one must consider whether or not any other offers and sales of securities are to be "integrated" with the subject intrastate offering since the restriction is keyed to the period of offers and sales of securities that are deemed "part of" the intrastate issue. Hence, if the offering period of such other integrated issue exceeds the offering of the subject intrastate issue, the restricted period must be measured by the integrated issue. This could be particularly severe in the case of warrants that are deemed integrated with an intrastate issue under the rule, since the restricted period will continue for the life of the warrants plus nine months.¹⁸⁷ Any sale or resale of any part of the integrated issue to nonresidents will, of course, render the rule and the exemption unavailable to the intrastate issue.

It is also possible that the offering period and the nine-month period will not be consecutive, but may overlap. In a slow-selling offering, for example, in which the last sale was made in January but the offering continued without success through October of that year when it was terminated, resales could begin immediately thereafter since more than nine months had elapsed since the last sale.

The nine-month limitation codifies with more precision the Commission's long standing position against the creation of interstate trading markets shortly after an initial intrastate offering. Underwriters and dealers involved in offerings under the rule will continue to have the same obligations and liabilities with respect to resales that existed prior to the adoption of the rule,¹⁸⁸ but will have the benefit, in offerings made under the rule, of greater certainty as to when an interstate trading market can develop. Exclusively intrastate trading can take place during

¹⁸⁶ The subparagraph measures both the offering period and nine-month period from offers or sales "by the issuer." Presumably this will be interpreted to mean "by or on behalf of the issuer or any underwriter." Otherwise, for example, a literal construction would permit resales to nonresidents nine months after the issuer's initial sale to a firm commitment underwriter, even though the underwriter continued offers and sales in distribution for more than nine months. Such a result would surely be outside the intent and purpose of the rule, as it would sanction the simultaneous occurrence of the original distribution and resales to nonresidents.

¹⁸⁷ See notes 133-135 *supra* and accompanying text and note 166 *supra*.

¹⁸⁸ See notes 31-32 *supra* and accompanying text, and rule 147(e), note 2 *supra*.

the nine-month period,¹⁸⁹ although dealers acting as principal must also be residents of the state (*i.e.* have their principal office or principal residence within the state).

A note to rule 147(e) provides that in the case of convertible securities resales of the convertible security or the underlying security must be confined to residents during the restricted period, but that a conversion in reliance on § 3(a)(9) of the Act¹⁹⁰ does not begin a new period. This suggests that the Commission, by implication, has confirmed its prior policy that after the restricted period the convertible security may be resold to and later converted by nonresidents. The rule is silent regarding warrants and options, but in Release 5450 the Commission stated: "In the case of warrants and options, sales upon exercise, if done in reliance on the rule, would begin a new period."¹⁹¹ As warrants and options constitute a continuing offer of the underlying securities,¹⁹² the import of the Commission's statement is that warrants and options sold pursuant to the rule may be exercised only by residents, and upon exercise the underlying securities cannot be resold to nonresidents for a nine-month period thereafter—and this is true whether they are exercised during or after the nine-month period following the original offering of the warrants or options by or on behalf of the issuer. Neither the rule nor Release 5450 specifically treats the questions arising with installment or deferred sales as a result of a subsequent change in the state of residency of the purchaser, and the considerations relevant prior to the adoption of the rule should be equally applicable to offerings made under the rule.¹⁹³

F. *Precautionary Measures*

Rule 147(f) requires issuers to effect certain mechanical procedures

¹⁸⁹ With regard to the restrictions on the activities of underwriters, dealers and other participants during the distribution of securities, see § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970) and the regulations promulgated thereunder, particularly rule 10b-6, Reg. § 240.10b-6, 2 CCH FED. SEC. L. RPTR. ¶ 22,726, regarding the prohibitions against manipulations by persons interested in a distribution, and rule 10b-7, Reg. § 240.10b-7, 2 CCH FED. SEC. L. RPTR. ¶ 22,727, regarding restrictions on the stabilization of prices during distribution. For a practical analysis of these provisions from the underwriter's and dealer's perspective, see Wing, *Guidelines for Underwriter Activity*, 25 BUS. LAW. 397 (1970). The administrative policy and objectives underlying these provisions regarding stabilization and manipulation and the Commission's determinations as to what activities are prohibited is treated in Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691 (1964).

¹⁹⁰ 15 U.S.C. § 77c(a)(9) (1970).

¹⁹¹ SA Rel. 5450.

¹⁹² See note 166 *supra*.

¹⁹³ See note 138 *supra* and accompanying text.

designed to preserve the exemption provided by the rule and notify offerees and purchasers of the resale restrictions. The required steps are: (1) placing a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the applicable resale restrictions under rule 147(e); (2) issuing stop transfer instruments to the issuer's transfer agent, or, if the issuer transfers its own securities, making a notation in its stock records; and (3) obtaining a written representation from each purchaser as to his residence.¹⁹⁴ If during the restricted resale period under rule 147(e) any outstanding certificates for securities constituting a part of the offering are presented for transfer, the issuer is also required to place the legend on, and issue stop transfer instructions (or make the appropriate notations) with respect to, the newly-issued certificates.¹⁹⁵ The rule does not require the issuer to obtain a residency representation from the transferee, although it would be advisable to do so. Finally, the issuer is required to disclose in writing (presumably to each offeree and purchaser) the limitations on resale under rule 147(e) and the legend and stop transfer procedures required under subparagraph (f).¹⁹⁶ If a trading market is contemplated, it would be wise for these disclosures to also make clear the limited character of that market during the restricted period.

In the case of offerings continuing for an uncertain duration, the precise period during which resales are limited may not be known when the offers and sales are made, or even when the certificates are delivered. As a result, it will be practicable to include in the legend and required disclosures only a description of how the restricted period is computed. In these instances it generally would be advisable to notify each security holder as soon as the termination date of the restricted period is known.¹⁹⁷

The foregoing procedures specified in the rule, while sound measures to adopt in any intrastate offering, are mandatory and the failure to

¹⁹⁴ Rule 147(f)(1).

¹⁹⁵ Rule 147(f)(2).

¹⁹⁶ Rule 147(f)(3).

¹⁹⁷ The corporation laws of most states contain provisions generally to the effect that for a restriction on transfer to be enforceable against a transferee without actual notice, the stock certificate itself must warn of the restriction in sufficient detail to provide reasonable notice to a prospective transferee. See OHIO REV. CODE ANN. § 1701.25(B) (Page 1970); DEL. CODE ANN. tit. 8, § 202(a) (Supp. 1968); UNIFORM COMMERCIAL CODE § 8-204 (providing that a restriction on transfer imposed by the issuer of a registered investment security is ineffective unless noted conspicuously on the security). Once the termination date of the restricted period under rule 147(e) is known by the issuer, the purpose and intent of these state notification requirements would be best served by communication of that date to registered security holders and its addition to the legends on new certificates issued during the nine-month period.

observe any one of them would render the rule unavailable. Many of the smaller local businesses for which the rule is intended and their counsel will not be deeply versed in the intricacies of the federal regulation of securities, and the relief afforded by the rule, for which such an issuer would otherwise qualify, would be lost irrevocably as a result of ignorance of or some technical misstep in implementing these precautionary measures.¹⁹⁸ This is a harsh result, particularly when observance of the mandatory procedures carries with it no protection against liability arising from a prohibited resale of which the issuer or the underwriter had no knowledge or control.¹⁹⁹

III. CONCLUSION

The welcome objective standards provided by the rule with respect to residency and resales are achieved only at the expense of the highly restrictive doing-business standards and an overall technical complexity loaded with pitfalls for inadvertent loss of the rule's benefits. Many issuers that would otherwise have qualified for the exemption prior to the rule will be unable or unwilling to satisfy all of its restrictive conditions. For these issuers, reliance on the administrative and judicial interpretations for non-rule transactions will be venturesome at best, at least until the effect of the rule thereon has developed with greater clarity. Taken as a whole, rule 147 represents a narrowing of the intrastate offering exemption. If only for reasons of administrative consistency, it will be the basis for the Commission's interpretation and enforcement of § 3(a)(11). For similar reasons of consistency and the general influence of the Commission, as well as for the pragmatic reasonableness of some of the rule's interpretative standards, the courts are likely to construe § 3(a)(11) with great deference to the rule. As a result, the interpretation of the exemption represented by the rule will become the path from

¹⁹⁸ For example, if the issuer fails to place the legend required under rule 147(f)(1)(i) on a single certificate, the benefits of the rule could be lost for the entire issue. Similarly, the failure by an issuer which transfers its own securities to make a proper notation in its appropriate records, or the failure to issue a single stop transfer order when a transfer agent is used, would cause a technical violation of the rule and, perhaps, render the rule inapplicable for the entire issue.

¹⁹⁹ It is possible that without the knowledge of the issuer a purchaser in an intrastate offering under rule 147 could resell the security to an out-of-state transferee during the nine-month period in a face-to-face transaction where the nonresident transferee would not request a record transfer until after the period had expired. Despite the fact that the issuer had complied with all of the rule 147(f) precautions and was not aware of or a party to the interstate resale, under the strict language of rule 147(e) the issuer could lose the benefits of the rule for the entire offering. Moreover, this transaction would not appear to satisfy the pre-rule administrative requirements under § 3(a)(11) and, therefore, the intrastate exemption itself may be lost absent some due care or good faith defense. See note 31 *supra* and accompanying text.

which issuers will be hesitant to stray if another, even sounder, interpretation of a particular component is available only by assuming the risk of justifying it through litigation. In short, we can expect issuers to seek registration or compliance with some other exemptions for many local offerings that prior to the adoption of rule 147 would have been effected in reliance on § 3(a)(11).